

**DISTRIBUTION OF FINANCIAL RESOURCES AND  
CONSTITUTIONAL OBLIGATIONS IN DECENTRALISED  
SYSTEMS  
A COMPARISON BETWEEN GERMANY AND SOUTH AFRICA**

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## **DECLARATION**

I, the undersigned, hereby declare that the work contained in this dissertation is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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## **VERKLARING**

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## ABSTRACT

In this dissertation a comparative study is made of the constitutional accommodation of the distribution of financial resources and constitutional obligations to the various spheres of government in Germany and South Africa. Both countries have decentralised or multi-level systems of government and can be classified, in terms of current studies on federalism, as integrated or cooperative federal systems. An overview of the historical developments, the political contexts, the fundamental principles and the constitutional frameworks for government in Germany and South Africa is provided as a basis for the in-depth analysis regarding the financial intergovernmental relations in these countries. This study has shown that economic theory is important in the design of decentralised systems of government and that political and socio-economic considerations, for example, the need for rebuilding Germany after World War II and the need to eliminate severe poverty in South Africa after 1994, often play a dominant role in the design and implementation of decentralised constitutional systems. The economic theory applicable to decentralised systems of government suggests a balanced approach to the distribution of financial resources and constitutional obligations with a view to obtaining the most efficient and equitable solution. In both countries the particular constitutional allocation of obligations and financial resources created a fiscal gap that required some form of revenue sharing or financial equalisation. The German financial equalisation system has been developed over fifty years and is quite complex. It attempts to balance the constitutional aim of reasonable equalisation of the financial disparity of the *Länder* with the financial autonomy of the *Länder* as required by the Basic Law. The huge financial and economic demands from the eastern *Länder* after unification in 1990 placed an additional burden on the available funds and on the financial equalisation system. Germany currently faces reform of its financial equalisation system and possibly also bigger constitutional reform. The South African constitutional system is only a decade old and the financial equalisation system that is less complex than the German system, is functioning reasonably well but needs time to develop to its full potential. The system may however require some adjustment in order to enhance accountability, efficiency and

equity. A lack of sufficient skills and administrative capacity at municipal government level and in some provinces hampers service delivery and good governance and places additional pressure on the financial equalisation system. The *Bundesverfassungsgericht* and the Constitutional Court play important roles in Germany and South Africa in upholding the principle of constitutional supremacy, and make a valuable contribution to the better understanding of the constitutional systems and the further development thereof. This study has shown that clear principles in constitutional texts, for example, such as those contained in the Basic Law, guide the development of applicable financial legislation and add value to the provisions on financial equalisation and how they are implemented. These principles in the Basic Law are justiciable and give the *Bundesverfassungsgericht* an important tool to adjudicate the financial equalisation legislation. The study of the constitutional accommodation of the distribution of financial resources and constitutional obligations in Germany and South Africa is not an abstract academic exercise and should be seen in the particular political and socio-economic contexts within which the respective constitutions function. The need to give effect to the realisation of socio-economic rights, for example, the right of access to health services, places additional demands on the financial equalisation system. The South African society experienced a major transformation from the apartheid system to a democratic constitutional order that in itself has had a significant influence on financial intergovernmental relations. This dissertation focuses on a distinct part of constitutional law that can be described as financial constitutional law. This comparative analysis of the two countries has provided some lessons for the further development of South Africa's young democracy, in particular the financial intergovernmental relations system.

## OPSOMMING

In hierdie proefskrif is 'n vergelykende studie gemaak van die grondwetlike akkommodering van die verdeling van finansiële hulpbronne en konstitusionele verpligtinge tussen die onderskeie regeringsfere in Duitsland en Suid-Afrika . Beide lande het gedentraliseerde of multi-vlak regeringstelsels en kan, ingevolge huidige studies oor federalisme, geklassifiseer word as geïntegreerde of koöperatiewe federale stelsels. 'n Oorsig van die historiese ontwikkelinge, politieke kontekste, fundamentele beginsels en grondwetlike raamwerke vir regering in Duitsland en Suid-Afrika is verskaf as basis vir die in diepte ontleding van die finansiële interowerheidsverhoudinge in elke land. Hierdie studie toon aan dat ekonomiese teorie belangrik is in die ontwerp van gedentraliseerde regeringstelsels, endat politieke en sosio-ekonomiese oorwegings, soos die behoefte aan die heropbou van Duitsland na die Tweede Wêreldoorlog en die behoefte na 1994 om grootskaalse armoede in Suid-Afrika uit te skakel, dikwels 'n oorheersende rol speel in die ontwerp sowel as die implementering van gedentraliseerde grondwetlike stelsels. Die ekonomiese teorie van toepassing op gedentraliseerde regeringstelsels suggereer 'n gebalanseerde benadering tot die verdeling van finansiële hulpbronne en grondwetlike verpligtinge ten einde die mees doeltreffende en billike oplossing te kry. In beide lande het die besondere grondwetlike verdeling van verpligtinge en finansiële hulpbronne 'n fiskale gaping geskep, wat een of ander vorm van inkomsteverdeling of finansiële egalisasie verg. Die Duitse finansiële egalisasiestelsel is oor vyftig jaar ontwikkel en is redelik ingewikkeld. Dit poog om 'n balans te vind tussen die grondwetlike doelwit van redelike egalisasie van die finansiële ongelykhede tussen die *Länder* en die finansiële outonomie van die *Länder*, soos vereis deur die Duitse Grondwet. Die reuse finansiële en ekonomiese eise van die oostelike *Länder* na vereniging in 1990 het 'n verdere las op die beskikbare fondse sowel as die finansiële egalisasiestelsel geplaas. Hervorming van die finansiële egalisasiestelsel in Duitsland is tans op hande, en moontlik ook nog groter grondwetlike hervorming. Die Suid-Afrikaanse grondwetlike stelsel is maar nog net 'n dekade lank in werking en die finansiële interowerheidstelsel, wat minder ingewikkeld as die Duitse stelsel is,

funksioneer redelik goed en benodig tyd om tot sy volle potensiaal te ontwikkel. Die stelsel benodig dalk sommige verstellings ten einde verantwoordbaarheid, doeltreffendheid en billikheid te verhoog. 'n Tekort aan voldoende vaardighede en administratiewe vermoëns op munisipale regeringsvlak sowel as in sommige provinsies plaas addisionele druk op die finansiële egalasiesistelsel. Die *Bundesverfassungsgericht* en die Konstitusionele Hof speel belangrike rolle in Duitsland en Suid-Afrika ten einde die beginsel van die oppergesag van die grondwet in stand te hou, en maak 'n waardevolle bydrae tot beter begrip van die grondwetlike stelsel en die verdere ontwikkeling daarvan. Hierdie studie het aangetoon dat duidelike beginsels in grondwetlike tekste, byvoorbeeld dié wat in die Duitse Grondwet vervat is, die ontwikkeling van toepaslike finansiële wetgewing beïnvloed en waarde toevoeg tot die bepalinge oor finansiële egalisasie en hoe dit geïmplementeer word. Hierdie beginsels in die Duitse Grondwet is bereikbaar en gee die *Bundesverfassungsgericht* 'n belangrike instrument om die finansiële wetgewing te kan beoordeel. Die bestudering van die grondwetlike akkommodering van die verdeling van finansiële hulpbronne en konstitusionele verpligtinge in Duitsland en Suid-Afrika is nie 'n abstrakte akademiese oefening nie, en moet gesien word binne die bepaalde politieke en sosio-ekonomiese konteks waarbinne dit funksioneer. Die behoefte om gevolg te gee aan die realisering van sosio-ekonomiese regte, byvoorbeeld die reg op toegang tot gesondheidsorgdienste, stel addisionele eise aan die finansiële egalasiesistelsel. Die Suid-Afrikaanse gemeenskap het 'n grootskaalse transformasie beleef van die apartheid stelsel na 'n demokratiese konstitusionele orde, wat opsigself 'n beduidende invloed op finansiële interowerheidsverhoudinge het. Hierdie proefskrif fokus op 'n besondere deel van die staatsreg wat beskryf kan word as finansiële staatsreg. Die vergelykende analise van die twee gevallestudies het sekere lesse verskaf vir die verdere ontwikkeling van Suid-Afrika se jong demokrasie, in besonder die finansiële interowerheidstelsel.

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# **DISTRIBUTION OF FINANCIAL RESOURCES AND CONSTITUTIONAL OBLIGATIONS IN DECENTRALISED SYSTEMS – A COMPARISON BETWEEN GERMANY AND SOUTH AFRICA**

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## LIST OF ABBREVIATIONS

### Court reports

BCLR	Butterworths Constitutional Law Reports
<i>BVerfGE</i>	<i>Bundesverfassungsgericht</i>
CC	Constitutional Court
SA	South African Law Reports

### Publications

<i>BGBI</i>	<i>Bundesgesetzblatt</i>
<i>DÖV</i>	<i>Die Öffentliche Verwaltung</i>
<i>JURA</i>	<i>Juristische Ausbildung</i>
<i>JuS</i>	<i>Juristische Schulung</i>
SALJ	South African Law Journal
SAPR/PL	Suid-Afrikaanse Publiekreg/Public Law
Stell LR	Stellenbosch Law Review
THRHR	Tydskrif vir Moderne Romeins-Hollandse Reg
TSAR	Tydskrif vir Suid-Afrikaanse Reg

### Other abbreviations

ANC	African National Congress
CP	Constitutional Principle
CDU	Christian Democratic Union
CSU	Christian Social Union
DP	Democratic Party
<i>DDR</i>	<i>Deutsche Demokratische Republik</i>
<i>FAG</i>	<i>Finanzausgleichgesetz</i>

FFC	Financial and Fiscal Commission
<i>FKPG</i>	<i>Gesetz zur Umsetzung des Föderale Konsolidierungsprogram</i>
FRG	Federal Republic of Germany
<i>GG</i>	<i>Grundgesetz</i>
<i>Hrsg</i>	<i>Herausgeber</i> (editor)
IFP	Inkatha Freedom Party
MPNP	Multi-Party Negotiating Process
MTEF	Medium term expenditure framework
NP	National Party
OEEC	Organisation for European Economic Cooperation

# **DISTRIBUTION OF FINANCIAL RESOURCES AND CONSTITUTIONAL OBLIGATIONS IN DECENTRALISED SYSTEMS – A COMPARISON BETWEEN GERMANY AND SOUTH AFRICA**

- 1 Introduction**
  - 1 1 General background**
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## **Chapter 1 Introduction**

### **1 1 General background**

#### **1 1 1 Selection of country studies**

This thesis is a comparative study of the constitutional accommodation of financial intergovernmental relations in two decentralised constitutional systems, namely Germany and South Africa. The main question addressed is: How are the distribution of financial resources and the allocation of constitutional obligations to the various spheres of government constitutionally accommodated in Germany and South Africa? This study will attempt to explain both theoretical and practical aspects of financial intergovernmental relations in these two countries. The knowledge gained in this process may make a contribution towards the further development of South Africa's constitutional system which is still "governance under construction".

The South African dispensation is unique in many ways with effective government still challenged by many historical factors, for example the structural imbalances in education caused by apartheid, the unequal provision of services and the extremely uneven distribution of wealth. These factors must be addressed as a matter of urgency in order to bring about stability. New solutions have to be found,<sup>1</sup> and they must be implemented within the context of a modern constitutional state and the structure of government provided for in a supreme and justiciable constitution. The stakes are high; it is not only domestic stability that has to be secured. The new South Africa has to implement regional and international policies that will demonstrate to potential investors that it is an attractive market for investment; a vital ingredient for economic growth. The previous regime was an isolated one; the new one is a leader on the African continent and a prominent international player in areas such as reform in the United Nations (UN) and the World Trade Organisation (WTO).<sup>2</sup>

A comparative study such as this may deliver useful insights. The German example is used for specific reasons that will be discussed in more detail below. Despite South Africa's unique historical, political and economic features it has adopted a constitution which is based on arrangements, institutions and values that have been implemented in several other states and have been in place for a considerable period of time. In the South African context the comparative method is legitimate and is sanctioned by the Constitution.<sup>3</sup> The Constitutional Court has used the comparative method in several instances during the certification process.<sup>4</sup>

The challenge lies in identifying relevant benchmarks, while demonstrating an awareness of local needs and unique features. To some extent a comparison of "formal" aspects in constitutional arrangements is inevitable when the constitution making process is kept in mind. The process was inspired by several developments elsewhere in the world. It should also be remembered that the present South African

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<sup>1</sup> An example is Black Economic Empowerment (BEE), which is a complicated policy in terms of which domestic redistribution of wealth is to result; while existing rights and international obligations have to be accommodated.

<sup>2</sup> In the present Doha Development Round of the WTO India, Brazil and South Africa (the IBSA configuration) have become leaders for the developing world.

<sup>3</sup> See sec. 39 (1) of the Constitution of the Republic of South Africa, 108 of 1996.

<sup>4</sup> See for example paras 50, 71 – 73, 89 – 90 and 112 - 113 in *Certification of the Constitution of the Republic of South Africa, 1996* 1996 4 SA 744 (CC); 1996 110 BCLR 1253 (CC),

Constitution is a negotiated product; the negotiating parties brought their own views to the negotiations and they were often inspired by examples in other countries. The negotiated Constitution had to deliver, in addition to a basic framework of government, a contract and guarantee for peace and stability in a highly divided society.

After ten years under the new Constitution the different political challenges in South Africa are seen more clearly. South Africa is faced with strong demands for transforming society and forging national unity – and it has to do this within the decentralised structure of government where provinces are often directly responsible for the delivery of services. Some would have preferred a stronger unitary approach for South Africa, although this would not in itself necessarily guarantee the availability of officials and structures in places and locations where services are required. South Africa is in many ways a developing country, without the skills required for effective government at some levels. This demonstrates the need to take account of the dynamic nature of governance. Federalism on the other hand is a process that is influenced by contemporary needs. The “commerce clause” in the American constitutional jurisprudence has undergone different interpretations over time as the debate on the relations between federal and state powers has evolved.

German domestic developments after the Second World War took place in a different context. West Germany was faced by major challenges regarding reconstruction or “*Wiederaufbau*”, and these could be tackled within a framework of international support for its position as a Western ally in the Cold War and for being a founding member of the European Communities. The German people were divided along similar lines to those experienced in South Africa. The challenges of social and economic integration and “transformation” only had to be addressed after the reunification of Germany in 1990.

These factors and other historical differences influence the manner in which a comparative study is undertaken. One has to show an awareness of differences such as party-political and regional developments, while trying to clarify constitutional arrangements in their own settings. In this manner, it is believed, a comparison re the meaning of federalism and decentralised government remains possible and valid.

Other countries, for example Canada, India or Australia could also have been chosen to study as a comparison to South Africa. These mentioned countries fall within the broad category of federal or multi-level constitutional systems and would also have led to some interesting and valid discussions. Various constitutional systems, including these three, did have an influence on the shaping of the South African constitutional system after 1990 but the role of the German constitutional system in this process is quite significant. This significance is confirmed by the various high level discussions held between South African negotiators and German constitutional experts in South Africa as well as in Germany. These discussions helped to find solutions for some of the difficult questions that were addressed during the constitution making process. The German model laid the basis for the development of “co-operative government” as opposed to “competitive federalism” and for the establishment of the National Council of Provinces.<sup>5</sup> Despite certain differences between the construction and functioning of the two constitutional systems, including financial intergovernmental relations, there are similarities that justify a comparative study of this kind. A combination of factors as indicated below motivated choosing Germany. This choice was also made because of the specific focus of this thesis, namely the distribution of financial resources of the state in a decentralised system.

Federalism characterised German constitutional development since the early 19<sup>th</sup> century. The concept itself originates from the Latin word “foedus”, meaning covenant,<sup>6</sup> and has a long history. The foundation for government at a sub-national level predates the federal constitution as some of the *Länder* already existed when the Basic Law was adopted in 1949. The establishment and development of *Länder* governments and local administrations was one of the decisions taken by the Allied leaders at the Potsdam Conference in 1945.<sup>7</sup> The Federal Republic of Germany was only formally constituted in 1949 with the adoption of the Basic Law. Issues

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<sup>5</sup> Haysom *Federal Features of the Final Constitution* in Andrews & Ellmann (eds) *The Post-Apartheid Constitutions* (2001) 504 513.

<sup>6</sup> Elazar *Federalism: An Overview* (1995) 1.

<sup>7</sup> The aim of this conference of the leaders of the Allied Forces (Great Britain, the USA and France) and the Soviet Union, that took place in Potsdam, Germany from 17 July to 2 August 1945, was to lay the basis for the democratic development of post-war Germany and the eradication of Nazism; Kimminich *Deutsche Verfassungsgeschichte* (1987) 592; Klein *The Concept of the Basic Law* in Starck (ed) *Main Principles of the German Basic Law* (1983) 15 23.



relating to federalism dominated the discussions that led to the *Paulskirchenverfassung* in 1848.<sup>8</sup> A federal culture had developed over a long period of time in Germany, but was suppressed by the National Socialist Party in 1934. The development of Germany's constitutional system followed a “bottom up” approach. When the Allied Powers were engaged in discussions about Germany’s constitutional future after World War II, they generally favoured a federal system and built on the federal culture that existed in Germany prior to the War.<sup>9</sup>

This is in contrast to the “top down” approach followed in the development of South Africa's decentralised constitutional system. The Constitution of the Republic of South Africa adopted in 1993 created nine new provinces and provided for the establishment of local governments throughout South Africa. The Constitution was thus the origin of these new sub-national governments.<sup>10</sup> Unlike Germany, there is very little in terms of a historical culture of federalism in South Africa.<sup>11</sup> The constitutional system that was negotiated in the early nineties was new to South Africa and not based on any existing models or structures in the country.

Some differences between the fundamental principles on which the constitutional orders in Germany and South Africa are based, should be noted. The German Basic Law contains the following fundamental principles, namely:

“The Federal Republic of Germany shall be a democratic and social federal state”,<sup>12</sup>

The Constitution of the Republic of South Africa, 108 of 1996,<sup>13</sup> states:

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<sup>8</sup> Kilper & Lhotta *Föderalismus in der Bundesrepublik Deutschland* (1996) 35.

<sup>9</sup> See discussion under **2 1 1**; Kilper & Lhotta 79.

<sup>10</sup> Sec 124, 174 and Schedule 1 of the Constitution of the Republic of South Africa, 200 of 1993.

<sup>11</sup> See discussion under **1 1 3**.

<sup>12</sup> Art 20 (1) read with Art 79 (3) of the Basic Law for the Federal Republic of Germany, promulgated by the Parliamentary Council on 23 May 1949.

<sup>13</sup> This Constitution is not an Act of Parliament, but was adopted by the Constitutional Assembly. It can thus not be numbered as ordinary Acts of Parliament are numbered. Although the reference to Act 108 of 1996 is commonly used, it is technically wrong. In contrast, the 1993-Constitution was adopted by Parliament and could therefore be numbered as an Act of Parliament. See Van Wyk “’n Paar opmerkings en vrae oor die nuwe Grondwet” 1997 (60) *THRHR* 377 378.

“The Republic of South Africa is one, sovereign, democratic state founded on the following values:

- (a) human dignity, the achievement of equality and the advancement of human rights and freedoms,
- (b) non-racialism and non-sexism,
- (c) supremacy of the constitution and the rule of law,
- (d) universal adult suffrage, a national common voters role, regular elections and a multi-party system of democratic government, to ensure accountability, responsiveness and openness.”<sup>14</sup>

Some of the similarities, or at least comparable elements, in the two selected constitutional systems are:

- (i) The principle of constitutional supremacy;<sup>15</sup>
- (ii) The division of powers and functions, including the allocation of concurrent powers to the *Bund* and *Länder* and national and provincial governments respectively;<sup>16</sup>
- (iii) The role of the second chamber in the national legislative arena, where the *Bundesrat* in Germany provided a basis for the creation of the National Council of Provinces in South Africa; and
- (iv) The development of *Bundestreue* and co-operative government.

The German constitutional system, including the financial intergovernmental relations system, had some influence in the development of the new South African constitutional system.<sup>17</sup> In the area of financial intergovernmental relations, which will be discussed in more detail later in this dissertation, there are both differences and similarities. While there is an important difference in the allocation of the main taxes in Germany and South Africa, both systems recognise the need for financial equalisation of some kind, or special dedicated funding such as the Structural Fund

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<sup>14</sup> Sec 1 of the 1993-Constitution.

<sup>15</sup> Art 20 of the Basic Law; sec 1 and 2 of the Constitution of the Republic of South Africa, 108 of 1996, (the 1996-Constitution).

<sup>16</sup> Art 74 and 74a of the Basic Law; sec 44 (1) (a) (ii), sec 104 (1) (b) (i) and Schedule 4 of the 1996-Constitution.

<sup>17</sup> See discussion under 1 2.

and Cohesion Fund in the EU<sup>18</sup> in order to address the economic disparities between different *Länder* or provinces. Both make provision for financial equalisation mechanisms. The dire socio-economic conditions in post-war Germany and in the new *Länder* after the reunification of Germany placed huge demands on government, both at a federal and at the *Länder* level. Financial equalisation mechanisms had to be developed and utilised to address questions such as poverty, economic development and welfare. One of the legacies of apartheid in South Africa was the huge gap between rich and poor throughout the country. Large-scale poverty, in particular in the rural areas, is one of the biggest challenges for government. The socio-economic needs and disparities between various communities and between provinces in South Africa have been put in the spotlight since 1994 after the establishment of the new democratic South Africa. This bears some resemblance to the socio-economic position in Germany shortly after 1949 and again in the period after 1990. Similar challenges were faced by government in South Africa and financial equalisation mechanisms had to be designed and implemented to address some of these socio-economic questions.

In addition to the purely constitutional issues highlighted above, the socio-economic scenarios in South Africa and Germany at important periods in their history provide further justification for a comparative study of this kind using these two countries.

### **1 1 2 Recent constitutional history in Germany and South Africa**

The last decade of the twentieth century saw some of the most significant constitutional developments in the history of both South Africa and Germany. The unification of Germany in 1990<sup>19</sup> was arguably the most important development in the history of modern Germany since the adoption of the Basic Law in 1949.<sup>20</sup> This took place at the same time that a process of radical constitutional change in South

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<sup>18</sup> These Funds are special EU funds to support development in the least developed regions within the EU in order to eventually strengthen the socio-economic “cohesion” of member states within the EU.

<sup>19</sup> *Vertrag zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik über die Herstellung der Einheit Deutschlands (Einigungsvertrag)*, agreed to on 31 August 1990 between the Federal Republic of Germany and the *Deutsche Demokratische Republik*; Von Münch *Staatsrecht* Band I (1993) 27.

<sup>20</sup> The Parliamentary Council signed and promulgated the Basic Law for the Federal Republic of Germany on 23 May 1949 at Bonn. For a discussion of the events preceding the promulgation of the Basic Law see Von Münch *Staatsrecht* 18 et seq; Laufer & Münch *Das föderative System* 68.

Africa started.<sup>21</sup> In Germany, a country divided as a consequence of war and ideology, the unification that took place in the aftermath of the fall of the Berlin Wall in November 1989, was a significant political development that changed the course of history. Although constitutional changes were made to the German Basic Law in order to extend its application to the former *Deutsche Demokratische Republik* (DDR), these changes were not as dramatic as those seen in South Africa because the DDR (East Germany) was incorporated into an existing legal order. Ideology has divided South Africa for decades, and significant changes had to take place before a new South Africa could be created. This required radical reform of the constitutional order to establish an all-inclusive constitutional democracy that inter alia guaranteed the protection of individual rights for all South Africans and established the rule of law and supremacy of the constitution.

In the beginning of 1990 the then State President of South Africa, F. W. de Klerk, made the opening moves in the constitutional transformation process in South Africa when he announced the unbanning of a number of political movements and the release of Nelson Mandela and other political prisoners from jail.<sup>22</sup> In May 1990 the first official meeting between the two major political forces, namely the existing National Party government and the African National Congress (ANC), the most important political grouping outside Parliament at that time, took place in Cape Town. This historical meeting produced the Groote Schuur Minute, an agreement that identified the obstacles to be removed before proper negotiations could start.<sup>23</sup>

After a protracted period of various rounds of multi-party negotiations during the first three years of the nineties, the South African Parliament adopted an interim constitution on 22 December 1993. This radically changed South Africa's

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<sup>21</sup> The State President of South Africa at the time, F W de Klerk, made an important announcement on 2 February 1990 to start political negotiations with all political groupings and to unban prohibited political groupings. The first meeting of political groupings under the name of Codesa, i.e. the Conference for a Democratic South Africa, took place on 21 December 1991 at Kempton Park. It later also became known as the Multi-Party Negotiating Process (MPNP).

<sup>22</sup> These announcements were made in Pres De Klerk's speech at the opening of Parliament on 2 February 1990.

<sup>23</sup> De Klerk *The Process of Political Negotiation: 1990 - 1993* in De Villiers (ed) *Birth of a Constitution* (1994) 16.

constitutional order.<sup>24</sup> The nature of the constitutional system, including its structural elements were hotly debated at the multi-party negotiations in Codesa as well as in the debates in the Constitutional Assembly. Various constitutional models were investigated and political parties made their representations to indicate their preferences for particular models or combinations of elements from various different models.

The more salient features of the constitutional debate and important concepts, such as federalism, will be discussed in the following sections, but before doing so, it should be recalled that South Africans were at war with each other at this time and that the constitution had to produce a formula for peaceful government. It had to address the fears of minorities and had to provide an effective framework to undo the legacies of apartheid. This had to be achieved against the background of an important reality – South Africa was one single state. Fragmentation into different nations was not an option and the failed homelands experiment served as a reminder of what the only remaining choice was. Against this background it is easy to understand why some political parties put such emphasis on federalism as a constitutional model and why this was such a hotly debated issue.

### **1 1 3 The federalism question**

One of the fundamental questions in these debates was whether South Africa should have a unitary system of government or a federal system, and what degree of centralisation or decentralisation there should be. The constitutional system that existed until 1994 in South Africa fell within the category of unitary systems, and there was not much of a federal constitutional tradition. In the discussions and correspondence between some of the British and Afrikaner leaders prior to the National Convention in 1908, a federal system was initially thought to be the best model for unification of southern Africa. There was even a decision to that effect in

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<sup>24</sup> The Constitution of the Republic of South Africa 200 of 1993, which was assented to by State President FW de Klerk on 25 January 1994 and commenced on 27 April 1994. See Ebrahim *The Soul of a Nation* (1998) 170 and 173. This constitution was an interim constitution in terms of which an elected Constitutional Assembly had to draft a new Constitution. The newly elected Parliament acted as the Constitutional Assembly, which negotiated and drafted a new Constitution based on a set of 34 Constitutional Principles adopted at the Multi-Party Negotiating Forum at Kempton Park in 1993.

the Cape Assembly in July 1907.<sup>25</sup> Two of the most prominent leaders at the time, General Jan Smuts and John X. Merriman, together with Sir Henry de Villiers, Chief Justice of the Cape, who presided over the National Convention, studied the federal constitutions of the United States of America, Canada and Australia but were not convinced of the merits of a federal system. Smuts drafted a suggested constitutional scheme for “South African Union”, which was supported by Merriman and others, and this formed the basis for the constitutional text produced by the National Convention where the constitutional debates resulted in a unitary system of government, based on the Westminster model, for South Africa.

The political adversaries participating in the South African negotiations of the 1990’s did not have the same understanding of terms such as “unitary system”, “unity”, “federalism” and “federal system”. Proponents of a federal system saw it as a constitutional system that could accommodate the diverse needs and circumstances of South Africa.<sup>26</sup> The Inkatha Freedom Party, one of the main supporters of a federal system, wanted fairly autonomous provinces and a “bottom up” approach of constitutional development similar to that of the United States of America.<sup>27</sup> In contrast, the advocates for a unitary system argued that a federal system could fragment South Africa or lead to secession of regions. For the African National Congress and some of the other parties a federal system reminded them of the failed apartheid system with its homelands and they therefore opposed it.<sup>28</sup> This view was further supported by strong centralist ideas expressed by some political parties,

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<sup>25</sup> Thompson *The Unification of South Africa 1902 – 1910* (1959) 101 – 103; Davenport *South Africa: A Modern History* (1987) 245.

<sup>26</sup> The South African Government of that time expressed its support for a federal system in various policy documents, eg *A new South Africa – documents on constitutional reform* dated 12 February 1993, where it stated on 5 thereof: “interests existing in certain regions or local environments can best be served by the devolution of functions to autonomous regional and local governments. The Government and the National Party are looking at five to nine provinces. The powers, functions and boundaries of each are to be entrenched in the constitution in such a way that no amendment thereof is possible without the concurrence of the government of that province.” See also Welsh “Federalisme ‘n kuur vir gevare van eenparty-demokrasie” in *Die Burger* (1995/03/16) 13.

<sup>27</sup> The IFP stated in one of their policy documents (*WTC 193* dated 24 June 1993) at the Kempton Park process “the IFP proposal would establish federalism and entrench SPRs [states/provinces/regions] before the empowerment of a new government and would ensure that the existing territorial local autonomy is transformed into SPRs without having to be previously reincorporated into the four existing provinces.” See also *Certification of the Constitution of the Province of KwaZulu-Natal, 1996* 11 BCLR 1419 (CC) para 14.

<sup>28</sup> Haysom *Federal Features* 505; Welsh *The Provincial Boundary Demarcation Process* in De Villiers *Birth of a Constitution* (1994) 223 224.

although provision was made for provinces as a second tier of government.<sup>29</sup> Conflicting views on the scope of authority of provinces when compared to that of the national level of government created much debate. Terms such as “federalism” and “federal system” were given such a negative connotation that parties to the negotiations agreed to refrain from using them. The search for an appropriate constitutional system of government that would promote good and effective government, while accommodating the views of the various parties finally resulted in a compromise. A closer look at the contents of the system agreed upon in the end provides some clarity on the type of constitutional system adopted.

The 1993-Constitution created a new constitutional order consisting of three levels of government, namely a national, provincial and local level. Nine provinces were created as a consequence of various submissions made at the Multi-Party Negotiating Process, but more particularly due to the work of the Commission on the Delimitation/Demarcation of States/Provinces/Regions.<sup>30</sup> This Commission had to take into account a list of ten criteria, which included historical boundaries, demographic considerations and economic viability, before making recommendations to the Negotiating Council regarding the creation and boundaries of the new provinces.<sup>31</sup> The new provinces were legally created by the 1993-Constitution and received their powers from it.<sup>32</sup> This manner of constitutional development is in contrast to the development of the constitutional system of the United States of America, where a federation was formed by the unification of various pre-existing sovereign territories.<sup>33</sup> This distinction was emphasised by the Constitutional Court in *In re: Certification of the Constitution of the Province of KwaZulu-Natal, 1996*

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<sup>29</sup> See for example the ANC policy document *ANC Regional Policy* dated October 1992 where the governmental system is described in such a way as to create regional governments with concurrent powers with the “central” government, but that the central government will have overriding powers.

<sup>30</sup> This Commission was established by the Negotiating Council of the MPNP on 28 May 1993 and had to make recommendations to the Negotiating Council on the demarcation of the states/provinces/regions within 6 weeks. The Commission’s mandate was to make recommendations to the Negotiating Council on the boundaries of regions that were relevant to the electoral process as well as to the structures of the constitution that was the subject of negotiation. See *Report of the Commission on the Demarcation/Delimitation of SPRs* (31 July 1993) 4; Ebrahim Soul of a Nation 158.

<sup>31</sup> *Commission Report* 17; *Welsh Provincial Boundary Demarcation* 223 – 229.

<sup>32</sup> *In re: Certification of the Constitution of the Republic of South Africa, 1996* 1996 4 SA 744 (CC); 1996 10 BCLR 1253 (CC) (*First Certification Case*) paras 259 - 260.

<sup>33</sup> Elazar *Federalism: an overview* (1995) 38.

1996 11 BCLR 1419 (CC) para 14 when it inter alia found that "the provinces are the recipients and not the source of power."

In view of the fact that the 1993-Constitution represented an interim phase in South Africa's constitutional development, a set of 34 Constitutional Principles, that acted as the yardstick to test the new constitutional text, was adopted by the Negotiating Council of the Multi-Party Negotiation Process.<sup>34</sup> A number of these principles relate to the structural elements of the constitutional system, and inter alia provided for the allocation of powers to the national and provincial governments in a way that included both concurrent and exclusive powers.<sup>35</sup> In giving effect to these Constitutional Principles the new Constitution adopted by the Constitutional Assembly in 1996 contained detailed provisions on the establishment of a multi-level system of government or, as it is referred to in the 1996-Constitution, a three-sphere system of government.<sup>36</sup> There are significant differences between the two constitutions on this score. The question regarding the differences in the scope and substance of the powers allocated to provinces in the 1996-Constitution when compared to the position in the 1993-Constitution was an important issue considered by the Constitutional Court in the *First Certification Case*. The differences relate to a variety of issues, for example, the powers and functions of provinces over police matters, the taxing power of provinces and provincial powers and functions pertaining to local government.<sup>37</sup>

The debate about a proper label for the South African constitutional system continued even outside of the political negotiations. Academic writers expressed different views on the question of whether it is a federal or a unitary system. Erasmus and De Waal state in this respect, without discussing the question, that the Constitution does not create a classic federation.<sup>38</sup> Van Wyk, in a short commentary on the Constitution, argues with reference to the typical elements of federalism, that the South African

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<sup>34</sup> De Villiers *The Constitutional Principles: Content and Significance* in De Villiers (ed) *Birth of a Constitution* (1994) 37; *First Certification Case* paras 14 - 19.

<sup>35</sup> Constitutional Principle (CP) XIX in Schedule 4 of the 1993-Constitution.

<sup>36</sup> Sec 40 of the Constitution of the Republic of South Africa 108 of 1996; *First Certification Case* para 45.

<sup>37</sup> See 2 2 for a discussion of the characteristics of the 1993-Constitution and that of the 1996-Constitution.

<sup>38</sup> "Die Finale Grondwet: Legitimiteit en Ontstaan" 1997 (1) *Stell LR* 31 37.



system is “structurally” closer to a modern federation than to a classic unitary state.<sup>39</sup> In a fairly detailed discussion of this issue, Watts concludes that South Africa has indeed a hybrid system which contains elements typical of federations, but also some characteristics common to regionalized unitary states.<sup>40</sup> These are but a few of the numerous views expressed by various commentators about the nature of the South African constitutional system. It seems clear that one cannot, as often happened in the debates during the development of South Africa's constitution, merely use labels such as “federal” or “unitary systems” to accurately describe specific constitutional systems. A brief discussion of these concepts is necessary in order to lay a proper foundation for further discussions in this thesis.

The terms “federalism” and “federation” or “federal system” are often viewed as synonymous. It is, however, necessary to distinguish between them in order to provide clarity. “Federalism” describes the nature and basic features of a constitutional system, whereas “federation” or “federal system” describes the institutional organisation of federalism in one country. Elazar describes federalism as more than a structural arrangement, “it is a special mode of political and social behaviour as well”.<sup>41</sup> The modern view of federalism, as expressed by experts such as Watts and Elazar, is that it is not a static concept, but should rather be viewed as flexible and varied.<sup>42</sup> Originally this was not the case. Wheare in his classic work on federalism, *Federal Government*, held quite a narrow view on this subject. He described, with reference to the United States of America as an example of federal government, the federal principle as the method of dividing powers to produce a system that consists of independent central and regional governments.<sup>43</sup> Wheare focussed on the structural elements of the system and essentially described a system of competitive federalism where two levels of government operate independently and neither is subordinate to the other. Over time, the original concept, as Wheare defined

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<sup>39</sup> “n Paar opmerkings en vrae oor die nuwe Grondwet” 1997 (60) *THRHR* 377 391. This view is supported inter alia by Klaaren *Federalism* in Chaskalson et al *Constitutional Law of South Africa* (loose-leaf 1998) 5-1.

<sup>40</sup> *Is the New Constitution Federal or Unitary?* in De Villiers (ed) *Birth of a Constitution* (1994) 86.

<sup>41</sup> Elazar *Federalism: an Overview* 2.

<sup>42</sup> Watts *Contemporary Views on Federalism* in De Villiers (ed) *Evaluating Federal Systems* (1994) 1 7. See also Delmartino and Deschouwer *Grondslagen van het Federalisme* in Alen et al *Federalisme – Staatskundig, politiek en economisch* (1994) 9 13; Mackenstein *From Cohesion Policy to Financial Equalisation?* (1997) 34.

<sup>43</sup> Wheare *Federal Government* (1956) 11.

it, developed into a wide spectrum of constitutional systems, supporting the notion of a flexible approach.<sup>44</sup> The spectrum includes many variations and one can perhaps say that each federation is *sui generis*. Global as well as national political and socio-economic developments have an impact on the role and functions of all states, including federal systems. Federal constitutional systems today function within a particular modern context and are much more complex and comprehensive than the “classical” model described by Wheare.

Simeon distinguishes between two models of federalism, namely the divided model and the integrated model.<sup>45</sup> Canada and the USA are both examples of the divided model of federalism, where a clear division of federal (national) and provincial powers and institutions exists. An example of the integrated model of federalism, which is designed to integrate politics at the different levels of government, is Germany. The main features of the integrated model are shared powers, shared financial resources and co-operation between the various levels of government.

This background and the fact that the South African constitutional order is a tailor made dispensation, must be kept in mind while considering the contents of this thesis.

#### **1 1 4 Essential features of the South African and German constitutional systems**

It is true that South Africa is neither a classic federation nor a unitary state. It may resemble some federations such as Germany, but the constitutional system contained in the 1996-Constitution should rather be described as a hybrid system as Watts has done.<sup>46</sup> Another, perhaps more appropriate, description would be to describe it as an “integrated federal system” in accordance with Simeon’s classification.<sup>47</sup> The distinct structural features of an ‘integrated federal system’ are:

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<sup>44</sup> See Elazar *Federalism: an overview* 2 – 18 for a useful discussion of the theory and various forms of federal systems.

<sup>45</sup> “Considerations on the design of federations: the South African constitution in comparative context” 1998 (13) *SAPR/PL* 42 50.

<sup>46</sup> See n 42.

<sup>47</sup> Simeon 1998 (13) *SAPR/PL* 59.

- ◆ A three sphere system of government, namely national, provincial and local government;<sup>48</sup>
- ◆ Constitutional division of powers and functions amongst the three spheres of government, where the majority of powers and functions are allocated concurrently to national and provincial governments;<sup>49</sup>
- ◆ Division of fiscal resources where the bulk of the taxing powers vests with the national government;<sup>50</sup> and
- ◆ Co-operative government as overarching guiding principle.<sup>51</sup>

In Simeon's analysis of the Canadian and German models as two clear examples of divided and integrated federal systems respectively, it is evident that the model South Africa has chosen resembles the integrated model of Germany more than the divided federal system of Canada.<sup>52</sup> This further supports the selecting of Germany as a comparison to South Africa for the purposes of this thesis.

In the period immediately after the end of World War II, there was extensive debate over the nature of the new constitutional system to be created for Germany. The federal model was agreed to be the more acceptable and this agreement was the point of departure for the shaping of the Basic Law. ("Federal" is in fact incorporated in the name of the country, namely the Federal Republic of Germany.) Historically there was a strong federal tradition in Germany, and the Allied powers emphasized this when they considered the nature of the constitutional system for Germany after the War. The first territorial entities formally recognised by the Allied Powers were the three *Länder*; Bavaria, Hessen and Württemberg-Baden. These were constituted on 19 September 1945.<sup>53</sup> This was the first step in the process of re-building democratic rule in Germany and an expression of the federal character of the system being developed, at least as far as the western part of Germany was concerned. In the

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<sup>48</sup> Sec 40 of the 1996-Constitution.

<sup>49</sup> This is dealt with in various provisions in the 1996-Constitution, eg sec 44 (legislative authority of Parliament); sec 104 (legislative authority of provincial legislatures); sec 156 (powers and functions of municipalities); Schedule 4 (functional areas of concurrent legislative jurisdiction) and Schedule 5 (functional areas of exclusive provincial legislative competence).

<sup>50</sup> Sec 228 of the 1996-Constitution.

<sup>51</sup> Sec 41 of the 1996-Constitution.

<sup>52</sup> Haysom *Federal Features* 507, 513; Simeon 1998 (13) *SAPR/PL* 68.

<sup>53</sup> Von Münch *Staatsrecht* 17; Kilper & Lhotta *Föderalismus in der Bundesrepublik Deutschland* (1996) 83.

Soviet occupied zone, (what became known as the German Democratic Republic (GDR) or the *Deutsche Demokratische Republik (DDR)*), a centralised, unitary system was created. This initially included five former *Länder* which were later divided into 14 *Bezirke* (districts) and developed towards a typically communist dispensation.

At the time of the unification of the two Germany's the nature of the new system was again a point of discussion. For decades the federal ideology was dead in the *DDR*. The democratic revolution of 1989, however, gave new life to the notion of federalism, as this was the constitutional philosophy of the other part of Germany, the Federal Republic of Germany (FRG). The growing support for "federalisation" and decentralisation in the *DDR* eventually assisted the unification process.<sup>54</sup> The coalition government of the *DDR* elected on 18 March 1990 officially expressed their support for refederalisation of the *DDR* by proclaiming as one of their aims, the creation of a federal republic.<sup>55</sup>

The implementation of the federal principle by way of the creation of new *Länder* and their incorporation into existing federal structures, was an important part of the establishment of the new unified Germany. Through the *Vertrag über die Schaffung einer Währungs-, Wirtschafts- und Sozialunion*, the first of three treaties between the Federal Republic of Germany and the *DDR*, the legal basis was laid for unification and the development of federal structures in the *DDR*.<sup>56</sup> In the ensuing process, the governments of the West German *Länder* provided guidelines for federalism in a unified Germany and this contributed to the eventual Unification Treaty signed on 31 August 1990.<sup>57</sup>

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<sup>54</sup> For a discussion of this important chapter in Germany's constitutional history see Laufer & Münch *Das föderative System* 76 - 83.

<sup>55</sup> "Es ist das Ziel, eine föderative Republik zu schaffen, einschließlich einer notwendigen Länderkammer" Coalition agreement of the *DDR* coalition government. See Laufer & Münch *Das föderative System* 77.

<sup>56</sup> This treaty was signed on 18 May 1990. See Von Münch *Staatsrecht* 27; Laufer & Münch *Das föderative System* 79.

<sup>57</sup> A document titled *Eckpunkte für den Föderalismus im vereinten Deutschland* was produced by the *Länder* governments on 5 July 1990. See Von Münch *Staatsrecht* 27; Laufer & Münch *Das föderative System* 80.

Today the German constitutional system is characterised by a number of federal elements,<sup>58</sup> such as the recognition of *Länder*, each with its own elected parliament and government, and the establishment of the *Bundesrat*, the chamber representing the *Länder* governments in the federal parliament. These elements will be discussed later in the thesis.

The fundamental principles of the German constitutional system are stipulated in Article 20 of the Basic Law, which describes Germany as a democratic and social federal state ("*ein demokratischer und sozialer Bundesstaat*").<sup>59</sup> These principles are protected against any constitutional amendment.<sup>60</sup>

It is, however, not only the Basic Law that lists the principles of the constitutional system. The German Constitutional Court (*Bundesverfassungsgericht*) has made a major contribution by developing one of the essential principles of the German constitutional systems, namely *Bundestreue*, or the federal comity principle.<sup>61</sup> In view of the significant role of this principle to the functioning of modern Germany, it is apt to describe the German system as one of co-operative or integrated federalism.

The principle of *Bundestreue* formed the basis for the adoption of a set of principles on co-operative government contained in the South African Constitution. The importance of this principle to the functioning of the constitutional system, including the financial intergovernmental relations, in both South Africa and Germany, warrants a more detailed discussion which will follow.<sup>62</sup>

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<sup>58</sup> Karpen *Federalism* in Karpen (ed) *The Constitution of the Federal Republic of Germany* (1988) 205 209.

<sup>59</sup> Art 20 Par. 1: "The Federal Republic of Germany shall be a democratic and social federal state." See Currie *The Constitution of the Federal Republic of Germany* (1994) 18.

<sup>60</sup> Art 79 (3) of the Basic Law.

<sup>61</sup> Laüfer & Münch *Das föderative System* 94; De Villiers *Bundestreue: The Soul of an Intergovernmental Partnership* in *Konrad Adenauer Stiftung Occasional Papers* March 1995 15.

<sup>62</sup> Heun *The Evaluation of Federalism* in Starck (ed) *Studies in German Constitutionalism* (1995) 167 175.

### 1 1 5 Political context

A study of the constitutional systems in Germany and in South Africa respectively would not be complete without considering the political context within which these constitutional systems function. A brief reference to the political contexts in Germany and South Africa follows.

The constitutional development in Germany since 1949 and in South Africa post 1990 took place in different political contexts. Multi-party democracy is one of the cornerstones of the constitutional systems in both these countries. In Germany various political parties participated in the development and adoption of the Basic Law in 1949 and the first chancellor of the Federal Republic of Germany, Konrad Adenauer, came from the CDU/CSU.<sup>63</sup> The current chancellor, Gerhard Schröder, belongs to the other major political party in Germany, namely the SPD. The CDU/CSU and the SPD are the two major political forces within Germany. Between 1949 and 2004 different parties were in power in the various *Länder* and at the federal level, and most of the time a coalition of political parties formed a *Land* government or the federal government. One political party could be in government in one *Land*, but in opposition in another or in the *Bundestag*. It can happen, and is currently the case, that the CDU/CSU is in the majority in the *Bundesrat*, while the SPD is in the majority in the *Bundestag*. The political context in Germany is thus characterised by coalition politics and the fact that political parties change roles regularly from being in government to being in opposition. This particular political context has a direct impact on the functioning of the constitutional system, in particular financial intergovernmental relations, and creates an atmosphere where competition between the *Bund* and the *Länder* is quite acceptable.

After the first democratic election in South Africa in 1994 the political scene has been dominated by one party, namely the African National Congress (ANC). Various political parties participated in the general elections in 1994 and thereafter, but the

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<sup>63</sup> Laufer & Münch *Das föderative System der Bundesrepublik Deutschland* (1997) 69. The CDU (Christian Democratic Union) and the CSU (Christian Social Union) are in alliance and is often referred to as the “union parties”. The CDU/CSU and the SPD (Social Democratic Party) are the two major political parties in Germany.

results have indicated a continuously growing gap between the ANC, as majority party, and its closest rivals.<sup>64</sup> In terms of the 1993-Constitution, provision was made for institutionalised multi-party governments at both provincial and national level. This is referred to as government of provincial unity and government of national unity respectively.<sup>65</sup> This arrangement was part of the negotiated settlement concerning the composition of the executive during the period of transition and was not provided for in the new Constitution in 1996. Any coalition governments formed since then, for example in the Western Cape and in KwaZulu-Natal after the 1999 and 2004 elections, were voluntary and not in terms of a prescribed constitutional formula.<sup>66</sup> It should be noted that for the first ten years of democracy the ANC was in power in seven of the nine provinces and after the 2004 elections it governs in all nine provinces, albeit with the support of other parties in Western Cape and KwaZulu-Natal.<sup>67</sup> Despite the fact that politics in South Africa is dominated by the ANC, there are a variety of political parties represented in the National Assembly as well as within the provincial legislatures and they all contribute to the development of democracy in South Africa.

The political context in South Africa is characterised by the dominance of the ANC and a lack of competition (or perhaps the deliberate exclusion thereof by the ANC) between provinces and the national government. This political context clearly influences the way in which the constitutional system is functioning, in particular the financial intergovernmental relations.<sup>68</sup>

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<sup>64</sup> In 1994 the ANC received 62, 65% of the votes for the National Assembly with the National Party its main opposition at 20,39% support. The ANC support increased in 1999 to 66, 36%, and increased further in 2004 to 69, 69% of the votes for the National Assembly with the Democratic Alliance, the official opposition, at 12, 37%; see [www.elections.org.za](http://www.elections.org.za) for detailed results of the 1994, 1999 and 2004 elections.

<sup>65</sup> Sec 84 (Executive Deputy Presidents), 88 (Cabinet), 94 (Appointment of Deputy Ministers) and 149 (Executive Councils) of the 1993-Constitution.

<sup>66</sup> Malherbe & Brand *Sub-National Constitutional Law* in Alen, A. et al *International Encyclopedia of Laws – Sub-National Constitutional Law* (2001) 34.

<sup>67</sup> There is a coalition between the IFP and the ANC in KwaZulu-Natal, while in the Western Cape the ANC initially formed a government with the New National Party, who later decided to join the ANC.

<sup>68</sup> See discussion in **Ch 6**

## **1 2 Financial intergovernmental relations: Germany and South Africa**

The main objective of this thesis is to provide a comparative analysis of the way financial intergovernmental relations are structured and given effect in Germany and South Africa.

The German experience is a rich source for comparative study due to its specific need to seek a balance between the competing tendencies towards unity and diversity. This issue is also central to South Africa's system of financial intergovernmental relations, and was particularly so during the first few years of the new democracy. A comparative study of this kind may contribute to the shaping of South Africa's fledgling system of financial intergovernmental relations, however it will require refinement and expansion in order to make it suitable for South Africa's circumstances and needs.

In the wide range of federal systems in existence today, the degree of decentralisation or centralisation or, according to Simeon, the degree of conflict or co-operation in a particular system, provides some indication of the character of that particular system.<sup>69</sup> Irrespective of the way federal systems are described, the concepts of subsidiarity and solidarity, described below, play a role in their development. In the constitutional systems of both Germany and South Africa, which are characterised by co-operation rather than conflict, the concepts of subsidiarity and solidarity are particularly relevant. This study will discuss the constitutional accommodation of these concepts and the role they play in regulating financial intergovernmental relations in both Germany and South Africa.

Subsidiarity is a guiding principle in a multi-level system of government. Although this principle is today used in the context of constitutional law and democratic rule, it has its origin in early Roman Catholic studies, where it was used to limit the sovereignty of the state, and later used in the development of constitutional legal theory. According to Johannes Althusius subsidiarity is linked to multi-tiered systems

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<sup>69</sup> The federal principle allows for unity amongst a number of constituent units, but at the same time for some degree of independence of those units. See Heun *The Evaluation of Federalism* 168; Simeon 1998 (13) *SAPR/PL* 50; Mackenstein *Financial Equalisation* 14..



of government. He wrote in as early as 1614, that subsidiarity required that the lower level of government be entitled to regulate its own affairs. Only in those matters that lower levels of government are not competent to regulate, should the higher level of government become involved.<sup>70</sup> In other words, in accordance with subsidiarity, governmental decisions in a multi-tiered system of government should be taken as closely to the citizens as possible, that is, at the lowest level of government possible.

Until the end of 1992 subsidiarity was not mentioned in the Basic Law. Due to the adoption of the Maastricht Treaty on the European Union, Article 23 of the Basic Law was amended to include a reference to the principle of subsidiarity and to provide for decision-making by the *Länder* and the Federal Parliament on European Union matters.<sup>71</sup> The Basic Law does not define the principle of subsidiarity, but gives effect to it in the German constitutional system, in particular in the context of the relationship between Germany and the European Union. It makes any future development of the European Union subject to the principles of democracy, rule of law, subsidiarity and the social and federal state. In the *Maastricht Case* (1993)<sup>72</sup> the *Bundesverfassungsgericht* concluded that the principle of subsidiarity does not create new powers for the European Union, but that it in fact limits its powers and that it imposes an obligation on the European Union to respect the identities of its member states.

The Maastricht Treaty on the European Union provides a description of the subsidiarity principle, but also demonstrates the need for compromise in an evolving regional system with strong supra-national features.<sup>73</sup> In this case, the concept

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<sup>70</sup> Würtenberger “The Principle of Subsidiarity as a Constitutional Principle” in Elwein et al *Jahrbuch zur Staats- und Verwaltungswissenschaft* (7) (1994) 65 65; Von Münch *Staatsrecht* 428.

<sup>71</sup> The Basic Law was amended on 12 December 1992. See Von Münch *Staatsrecht* 428.

<sup>72</sup> *BVerfGE* 89, 155 (12/10/1993).

<sup>73</sup> Art 3b of the *Treaty on European Union*, Maastricht, 7 February 1992 stipulates as follows: “The Community shall act within the limit of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.”

applies to a quasi-federal system which has governmental structures at the European Union (supra-national) level, the level of the member states and at regional (or local) level. In the context of constitutional law the subsidiarity principle has the aim of ensuring that functions and duties must be allocated to the lowest possible level of government that can effectively exercise them. Simeon rightly refers to the opposing effects this principle might have, namely that it can be used to promote centralisation, for example through the setting of national standards, while in other cases it can also be utilised to strengthen decentralisation.<sup>74</sup>

In South African constitutional history the subsidiarity principle is quite recent. It was included in the Constitutional Principles agreed to at the Multi-Party Negotiating Process at Kempton Park although it was not mentioned by name.<sup>75</sup> It was also not mentioned as such in the 1996-Constitution, but its recognition can be seen in various provisions, such as section 44 (1) (a) (iii) (assignment of national legislative powers to other legislative bodies), section 104 (1) (c) (assignment of provincial legislative powers to a municipal council) and section 156 (4) and (5) (assignment of the administration of certain matters to municipalities). In these provisions subsidiarity is used to strengthen decentralisation or the devolution of powers. The principles of cooperative government contained in Chapter 3 of the 1996-Constitution further support the notion of subsidiarity since it militates against the idea that everything must be initiated from the centre.<sup>76</sup>

The force of centralisation within a federal system is based on notions such as “unity” or “solidarity”, which can be seen as counterweights to the principle of subsidiarity. The concept of solidarity is a rather flexible notion that can be applied to a variety of situations. In European Union (EU) law, it is referred to in the Maastricht Treaty and appears to be a guiding principle in the efforts of the EU to reduce regional disparities

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<sup>74</sup> Simeon 1998 (13) *SAPR/PL* 52; see also Rautenbach & Malherbe *Constitutional Law* 3<sup>rd</sup> ed (1999) 93.

<sup>75</sup> CP XXI.1 of Schedule 4 of the 1993-Constitution stated:

"The level at which decisions can be taken most effectively in respect of the quality and rendering of services, shall be the level responsible and accountable for the quality and the rendering of the services, and such level shall accordingly be empowered by the Constitution to do so."

<sup>76</sup> Van Wyk "Subsidiariteit as waarde wat die oop en demokratiese Suid-Afrikaanse gemeenskap ten grondslag lê" in Carpenter (ed) *Suprema Lex* (1998) 251 266.

between rich and poor Member States and to promote economic and social cohesion amongst the Member States.<sup>77</sup> In the context of constitutional law, solidarity has a similar role to play. Mackenstein describes it as flowing from a recognition of unacceptable differences between various parts and the need for actions to reduce these differences in such a way that the stronger players assist the weak.<sup>78</sup>

The term solidarity does not appear in the German Basic Law. The concept nevertheless finds expression within the Basic Law and it plays an important role in the functioning of the German constitutional system. Solidarity is a key element of *Bundestreue* and should also be seen as related to the notion of a social state (*Sozialstaat*); one of the fundamental principles of the Basic Law.<sup>79</sup> The social state implies the achievement of a fair social order in Germany. It is aimed at the promotion of social justice and addressing the economic needs of all citizens irrespective of where they live.<sup>80</sup> Reducing disparities among rich and poor *Länder* is thus based on solidarity and the principle of a social state. The legal basis for this approach is also contained in the constitutional provision regarding the objective to ensure uniformity or equality in living conditions throughout the federal territory.<sup>81</sup>

In the South African 1996-Constitution the concept of solidarity is not stipulated as such, but it finds expression in a number of ways. The Preamble includes the phrase “united in our diversity”. In terms of the principles of co-operative government, all spheres of government and all organs of state must ensure the well being of the people of South Africa and must support and assist one another.<sup>82</sup> In the context of financial equalisation, solidarity must find some application. Although no specific reference to solidarity is made, it is constitutionally provided for that local government and each province is entitled to an equitable share of revenue raised nationally. One of the factors to be considered when the equitable division of revenue is determined is the

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<sup>77</sup> Art 2 of the Maastricht Treaty inter alia states: “The Community shall have as its task ...to promote throughout the Community ... the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.”

<sup>78</sup> Mackenstein *Financial Equalisation* 87.

<sup>79</sup> Art 20 (1) of the Basic Law.

<sup>80</sup> Von Münch *Staatsrecht* 115.

<sup>81</sup> Art 106 (3) 2 of the Basic Law; Mackenstein *Financial Equalisation* 88. This objective is discussed in detail in **Ch 5**.

<sup>82</sup> Sec 41 (1)(h)(ii) of the 1996-Constitution.

economic disparity within and among provinces.<sup>83</sup> It seems fair to argue that in accordance with the concept of solidarity, as described by Mackenstein, constitutional recognition is given to the need to address economic disparity in South Africa. In the South African context, where huge economic disparities amongst the provinces and amongst different parts of the country exist, solidarity must be accommodated. In the field of financial intergovernmental relations, the reduction of disparities among and within the provinces is an important aim both in South Africa as in Germany.

In discussing issues such as equivalence in living conditions, financial equalisation and financial autonomy of provinces and *Länder*, consideration will be given to the role of subsidiarity and solidarity. How the constitutional arrangements regarding the distribution of financial resources and constitutional obligations to the various spheres of government in Germany and South Africa will be considered and an assessment of the mechanisms developed in both countries to reduce regional disparities will be made. Hopefully, recommendations regarding the further development of South Africa's financial intergovernmental relations system will result from these discussions.

### **1 3 Context and approach**

This thesis, being a comparative study of a very specific part of constitutional law, namely the constitutional accommodation of financial intergovernmental relations may contribute to the substantial volume of academic writing published in Germany on this theme. In South African constitutional law this is still relatively new. This study will provide an overview of the main features of the two systems while the focus will be on the design and functioning of financial intergovernmental relations in the two countries. The constitutional accommodation of the allocation of constitutional obligations and the distribution of financial resources to the various levels or spheres of government will be discussed.

In decentralised systems of government, there tends to be rich and poor provinces or states, and rich and poor municipalities. This, according to economic theory, reflects

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<sup>83</sup> Sec 214 and 227 of the 1996-Constitution.

the underlying inequality in income distribution among individuals within the state.<sup>84</sup> The existence of financial disparities among the various constituent units in decentralised systems of government warrants some form of equalisation in order to reduce such disparities and to ensure an adequate and equitable provision of public goods and services to all.<sup>85</sup> The economic rationale for financial equalisation is based on two objectives, namely efficient allocation of resources throughout the country and equitable treatment of all citizens in the allocation of resources.<sup>86</sup> In addition to these economic reasons for financial equalisation, important policy considerations such as the promotion of political stability or the reduction of poverty should also be considered.

Financial equalisation or *Finanzausgleich*, which is a core element of the German system, is a particular mechanism used to address regional disparities in decentralised systems. In South Africa, where there are huge disparities in the economic situation in the various provinces, financial equalisation based on the equitable division of revenue is at the heart of the financial intergovernmental system. A comparison between the implementation of *Finanzausgleich* in Germany, where huge regional disparities occurred after World War II and after unification, and the equalisation approach in South Africa forms an essential part of this study. The profound impact of unification on financial intergovernmental relations, and specifically on *Finanzausgleich*, will be a focus point of this comparison. It will be argued that there are important parallels between the post 1990 situation in Germany and the post 1994 developments in South Africa.

This study falls within the realm of comparative constitutional law, but since it deals with a subject of constitutional law, with public finance and fiscal and economic features, consideration will be given to general economic theory as far as it relates to the subject matter under discussion.

Broadly speaking constitutional law ordinarily deals with two broad categories, namely the protection of human rights and organisational or structural matters such as

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<sup>84</sup> Musgrave *Public Finance in a Democratic Society* Vol III (2000) 413.

<sup>85</sup> Musgrave *Public Finance* 413.

<sup>86</sup> Boadway *Burden Sharing or Dividing the Spoils?* (1999) 3; see discussion under 3 4 2.

the division of powers between the legislative, executive and judicial arms of government. Allocation of powers and obligations to various levels or spheres of government as well as the distribution of financial resources, relate to the organisational part of constitutional law. The distribution of financial resources is not a theoretical exercise and must take cognisance of political and economic considerations within the country. Furthermore, the actual spending of money by various levels or spheres of government to deliver services and give effect to constitutional obligations, has political and economic implications. How does constitutional law deal with issues that relate to political or economic matters? For example, how does government decide on the allocation of funds to a poverty alleviation program in one part of the country? The principle of supremacy of the constitution means that the provisions on financial arrangements are in principle also justiciable. In view of the policy issues related to financial intergovernmental relations, the justiciability of the financial constitutional provisions is a complex matter. Specific attention will be given to the question regarding the justiciability of financial constitutional arrangements in **Chapter 7**.

There is no definite answer to the question whether the specific scope of this study suggests a *sui generis* part of constitutional law or not. However, it is argued that it is at least a distinct part of constitutional law that has some relation to public finance and fiscal and economic policy aspects pertaining to the distribution of financial resources and constitutional obligations. Häde, in his thorough analysis of the German financial equalisation system, commented that the nature of the subject suggests that matters relating to economic theory and political science should also be covered in a constitutional legal study of this kind.<sup>87</sup> However, it is not suggested that an economic analysis of the law should be undertaken.<sup>88</sup> It is rather a question of acknowledging the importance of economic and social issues and enriching the analysis of the specific part of constitutional law under discussion with an appropriate reference to economic theory, public finance and political science. It will be argued that a study of this distinct part of constitutional law, which could perhaps be

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<sup>87</sup> Häde *Finanzausgleich* (1996) 10.

<sup>88</sup> Posner *Law and Economics* (2001) 1475 et seq.

described as financial constitutional law, should at least include a discussion of the following issues, namely:

- ◆ Economic considerations in the design of financial intergovernmental relations in decentralised systems of government;
- ◆ The constitutional allocation of financial resources and expenditure functions to the various levels of government;
- ◆ The way in which the law (the constitution as well as ordinary legislation) deal with policy issues pertaining to financial intergovernmental relations; and
- ◆ The justiciability of legal provisions dealing with financial intergovernmental relations.

The main method adopted in preparing this study, was to analyse published sources on legal theory and practice in the two systems under discussion. A number of interviews were also conducted with academics, legal practitioners, politicians and officials in the two countries in order to get an understanding of the practical functioning of financial intergovernmental relations.

## **1 4 Overview of thesis**

This dissertation covers the period until 1 November 2004. This study is divided into six main chapters preceded by this introductory chapter and followed by a closing chapter in which some conclusions are drawn and recommendations made with a view to assist in the further development of South Africa's system of financial intergovernmental relations. The structure of this dissertation aims to deal with the various elements of financial constitutional law as suggested above.

In **Chapter 2** the basis is laid for the analysis of the financial intergovernmental relations in Germany and South Africa by providing an overview of the constitutional frameworks in these two countries. This chapter only provides a brief historical overview and an analysis of the main characteristics of the two systems, in particular with reference to financial intergovernmental relations. The role of the concept of *Bundestreue* and co-operative government is discussed in the closing part of **Chapter 2**. It will be argued that these concepts play an instrumental role in the functioning of financial intergovernmental relations in both countries.

**Chapter 3** starts with a discussion of the theory of public finance as it relates to decentralised systems of government. This is followed by an analysis of the economic considerations in the allocation of resources to sub-national governments in decentralised systems of government. A fiscal gap occurs when the allocation of expenditure is not matched by the allocation of financial resources to a particular level of government. In the final part of this chapter an analysis is provided of the economic considerations as well as the actual revenue sharing mechanisms and intergovernmental transfers that can be utilised to address the problem of a fiscal gap.

**Chapter 4** examines the actual constitutional accommodation of expenditure obligations and distribution of financial resources in Germany and South Africa respectively. This is done with a reference to the theoretical economic framework discussed in **Chapter 3**. It starts in the first part of the chapter with a discussion of the theoretical economic framework applicable to the functioning of decentralised systems of government. This is then compared with the actual constitutional accommodation of the division of financial resources in Germany and South Africa. An examination of the similarities and differences between the two systems underlines the fact that regional disparities exist in decentralised systems and it shows the need for particular mechanisms to take care of such disparities. Both countries have, with different objectives in mind, chosen particular constitutional formulations for the allocation of financial resources including financial equalisation mechanisms.

The discussion of the constitutional accommodation of financial equalisation in Germany and South Africa forms a major part of this thesis and is therefore covered in two separate chapters, namely **Chapter 5** and **Chapter 6**. This thesis will not be complete without an examination of some of the underlying fundamental issues that play a role in the design and functioning of financial intergovernmental relations in decentralised systems. Against the background of political and economic realities the actual allocation of financial resources and constitutional obligations in decentralised systems is never static. It means that the particular constitutional formulas might change over time due to a number of factors and issues relating to the particular constitutional model. The relevant factors and underlying fundamental issues in the two systems will receive attention in **Chapter 5** and **Chapter 6**.



**Chapter 5** contains an in-depth discussion of financial equalisation in Germany (*Finanzausgleich*). It is in this chapter that the practical application of the principles of equalisation as well as the consequences of the constitutional division of obligations and financial resources receive proper attention. The first part of this chapter is devoted to the development, design and functioning of the quite complex system of financial equalisation in Germany. A discussion of the reforms of the *Finanzausgleich* since 1949 as well as the effect of the unification of Germany in 1990 is covered in the second half of **Chapter 5**.

**Chapter 6** contains an analysis of the development of financial equalisation in South Africa, a system that is in existence only since 1997. This chapter also focuses on the application of the various elements of equalisation as they are applied in the South African context as well as the practical consequences of the constitutional division of financial resources and obligations. A comparative analysis between the financial equalisation system in Germany and that in South Africa is provided in the last part of the chapter, with a view to make some recommendations regarding the further development of financial intergovernmental relations in South Africa.

Reference will be made throughout the thesis to relevant case law, but since this study is a constitutional law study, separate consideration of the relevant case law pertaining to the main issues under scrutiny is thus provided in **Chapter 7**. Both Germany and South Africa have constitutional courts as important constitutional institutions. The role that the *Bundesverfassungsgericht* in Germany and the South African Constitutional Court plays in shaping the financial intergovernmental relations, in particular the constitutional accommodation thereof, will be highlighted in this chapter.

In the final chapter, **Chapter 8**, the main results are collated in order to justify the main objective of this study, namely to explain and analyse the constitutional distribution of financial resources and obligations in Germany and South Africa. In order to make a proper evaluation of the functioning of *Finanzausgleich* it is also necessary to consider the problems and challenges experienced in practice. In the examination of the current problems in the German system, it will be indicated

whether there are any lessons to be learned for the development of financial equalisation in South Africa. In scrutinising the financial equalisation mechanisms chosen after unification as well as the current reform initiatives in Germany, it will be indicated what guidance may be gained from the German experience in the design and application of financial intergovernmental relations, for South Africa. **Chapter 8** concludes with some proposals for reform in South Africa.

- 2 General constitutional framework**
  - 2 1 German constitutional system**
    - 2 1 1 Historical overview**
    - 2 1 2 Fundamental principles of German constitutional system**
  - 2 2 South African constitutional system**
    - 2 2 1 Historical overview**
    - 2 2 2 Fundamental principles of South African constitutional system**
  - 2 3 Co-operative federalism**

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## **Chapter 2 General constitutional framework**

### **2 1 German constitutional system**

#### **2 1 1 Historical overview**

The development of a federal idea in Germany is marked by a search for national political unity. The rise of Napoleon in Europe at the end of the eighteenth century not only led to a large empire under French rule, but also contributed towards the ending of the Holy Roman Empire of the German Nation in 1806. Emperor Franz II of Austria, the Emperor of the Holy Roman Empire issued a proclamation on 6 August 1806 to dissolve the Empire started by Charlemagne in 800<sup>1</sup> to prevent Napoleon being crowned as Emperor by the Pope in Rome.<sup>2</sup> This is seen as the end of the First German Empire and the end of any form of political organisation that links together the various German territorial entities.

The dissolution of the Holy Roman Empire caused the various kingdoms, principalities and other territorial entities on German soil that previously formed part of the Empire, to search for a new form of national political organisation – a search for the creation of a national German state. On 12 July 1806, 39 German principalities and other territorial entities formed the *Rheinbund* under the protection of Napoleon.<sup>3</sup>

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<sup>1</sup> Kimminich *Deutsche Verfassungsgeschichte* (1987) 15.

<sup>2</sup> Kimminich *Deutsche Verfassungsgeschichte* 286, 288.

<sup>3</sup> Kimminich *Deutsche Verfassungsgeschichte* 313; Laufer & Münch *Das föderative System der Bundesrepublik Deutschland* (1997) 34.

This was an attempt by Napoleon to consolidate the areas conquered, and was a first step in the search for political unity amongst the various German entities. There were two main schools of thought that supported the development of German unity, namely the unity movement (*Einheitsbewegung*) and the constitutional movement (*Verfassungsbewegung*). The first supported federalism and the joining of the various German states, the second school focussed on the limitation of power of the monarchies.<sup>4</sup>

The war against Napoleon was linked to the search for a new German constitutional structure. The defeat of Napoleon culminated in the Congress of Vienna (1 November 1814 – 9 June 1815), which created the opportunity for a re-organisation of Western Europe and included the shaping of German unity.<sup>5</sup> The formation in June 1815 of the *Deutscher Bund* (German Confederation) was an important milestone in the history of German federalism. It created a confederation of states consisting of a loose association of kingdoms, free German cities, principalities and other territorial entities, where Prussia and Austria were the main actors.<sup>6</sup> The purpose of the *Deutscher Bund* was to protect the external and internal German security, while recognizing the independence and inviolability of the various territorial entities.<sup>7</sup> In May 1820 the representatives of the various German states negotiated the *Wiener Schlussakte* in order to clarify matters not properly dealt with in the *Deutsche Bundesakte* and the *Wiener Kongressakte*. The nature of the *Deutscher Bund*, being a confederation of German states, is confirmed in the *Wiener Schlussakte*, that states that the *Deutscher Bund* is an international law association of sovereign German principalities and free German cities.

A political organ, the *Bundestag*, with its seat in Frankfurt, was created in terms of the *Deutsche Bundesakte*. Although this was not a parliament, it laid the foundation for some of the elements of the political organisation of modern Germany. The

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<sup>4</sup> Kimminich *Deutsche Verfassungsgeschichte* 297.

<sup>5</sup> Although the debate about Germany's constitutional future could be distinguished from the debate about the re-organisation of Europe, there was a close link between the two. This resulted in the inclusion of the *Deutsche Bundesakte* of 8 June 1815 in the *Wiener Kongressakte* of 9 June 1815. Kimminich *Deutsche Verfassungsgeschichte* 316 - 326; Laufer & Münch *Das föderative System* 34; Kaufmann *Bundesstaat und Deutsche Einheit* (1992) 14.

<sup>6</sup> Kimminich *Deutsche Verfassungsgeschichte* 321.

<sup>7</sup> Art 2 of the *Deutsche Bundesakte*; Kimminich *Deutsche Verfassungsgeschichte* 324; Laufer & Münch *Das föderative System* 34.

*Bundestag*, or Federal Assembly, consisted of delegates or representatives of the 39 German states (including the states of Baden and Württemberg that joined later in 1815) with Austria chairing the plenary meetings. The representatives were nominated and instructed by the various member governments and were not elected by the people. There was an unequal voting distribution, with each delegation having at least one vote and the larger states, such as Prussia, Austria and Bavaria, receiving up to four votes in the plenary meeting.<sup>8</sup> There was also a smaller council that discussed the more ordinary governmental matters. The organisation of and voting in this *Bundestag* clearly resembles the current situation in the *Bundesrat* that consists of representatives of the sixteen German *Länder* governments and where unequal voting arrangements exist. This is one of the significant characteristics of German federalism.

At the beginning of the nineteenth century there was a move towards economic integration between Prussia and other northern territories on the one hand and the southern states dominated by Bavaria on the other. Various customs unions were created between 1818 and the early 1830's in different parts of the Confederation. In 1829 a trade agreement was concluded between the Prussian-Hessen-Darmstadt *Zollverein* (customs union) and the Bavaria-Württemberg *Zollverein*. This eventually led to the formation of the German Customs Union (*Deutscher Zollverein*) in March 1833.<sup>9</sup> Liberalisation of trade and the economic integration of the German states were the main aims of this *Zollverein*. Over a period of about three decades, the *Deutscher Zollverein* succeeded in establishing an integrated German economy by eliminating the barriers to free trade that existed between the various territorial entities. On the political level it is evident that the *Zollverein* was an important step towards the process of German political unity.<sup>10</sup>

The winds of revolution that blew over Europe during the middle of the nineteenth century also affected Germany. In March 1848 various German states experienced revolutionary battles. At this time the search for a federal Germany with a solid

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<sup>8</sup> Kimminich *Deutsche Verfassungsgeschichte* 323; Laufer & Münch *Das föderative System* 35.

<sup>9</sup> Kimminich *Deutsche Verfassungsgeschichte* 403; Mackenstein *From Cohesion Policy to Financial Equalisation* (1997) 62.

<sup>10</sup> Kimminich *Deutsche Verfassungsgeschichte* 405; Mackenstein *Financial Equalisation* 63.

constitutional basis proceeded and led to the so-called *Paulskirchenverfassung*, a proposal for a new constitution discussed by the National Assembly that met in St. Paul's Church in Frankfurt in May 1848.<sup>11</sup> The National Assembly or *Deutsche Verfassungsgebende Nationalversammlung* consisted of 830 members directly elected by the people in the various member states. This constitutional proposal provided for radical constitutional changes. For the first time a constitution for the whole of Germany as a federal state was being developed. It was the first attempt to recognise basic human rights for Germany and to provide for the establishment of the *Rechtsstaat*.<sup>12</sup> Structurally the *Paulskirchenverfassung* provided for a constitutional monarchy based on federal principles.<sup>13</sup> The concept of a federal state (*Bundesstaat*) formed an important structural element in this constitutional proposal. It provided for a vertical division of powers, namely between the federal level and the constituent states. The proposal further included a two-chamber parliament, the *Reichstag*, consisting of a *Volkshaus* (house of assembly) and a *Staatenhaus* (house of states) based on the American model. Political developments in Prussia and Austria that consolidated the old order, however, contributed to the fact that the *Paulskirchenverfassung* was never implemented. Although this constitution should be seen as a proposal, it had a major impact on the political thinking and constitutional developments for Germany during the next century. This is evident in the Basic Law adopted 100 years later.

The *Deutscher Bund* eventually came to an end in 1866 when the Austrian-Prussian War ended with the defeat of Austria by Prussia under the leadership of Bismarck, who then formed the *Norddeutschen Bund* (North German Confederation).<sup>14</sup> The constitution of the North German Confederation inter alia made provision for a two chamber legislature of the *Bund*, consisting of the *Reichstag* and the *Bundesrat*, with Prussia getting 17 of the 43 seats in the *Bundesrat*. These consisted of representatives from the constituent states. The North German Confederation, dominated by Prussia, had a federal character and paved the way for future constitutional developments.

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<sup>11</sup> *Verfassung des Deutschen Reichs vom 28. März 1849*; Kimminich *Deutsche Verfassungsgeschichte* 355; Siemann "Griff der Nation" in *Zeitpunkte* 1/98 53.

<sup>12</sup> Currie *The Constitution of the Federal Republic of Germany* (1994) 3.

<sup>13</sup> Kimminich *Deutsche Verfassungsgeschichte* 358.

<sup>14</sup> Kimminich *Deutsche Verfassungsgeschichte* 406; Laufer & Münch *Das föderative System* 38; Kaufmann *Bundesstaat* 16.

The southern states, which included the Kingdom of Bavaria, decided to join the North German Confederation to establish the German Empire (*Deutsche Reich*), which consisted of twenty-five member states, in 1871.<sup>15</sup>

Under the leadership of the Minister-President of Prussia, Otto von Bismarck, who became the Chancellor of the *Reich*, a federal constitutional system was established with the adoption of the Constitution of the German Empire on 16 April 1871.<sup>16</sup> This new constitutional monarchy was dominated by Prussia and produced both the *Reichskanzler* (Bismarck) and the Emperor (King Wilhelm I). The federal nature of the system was underlined by the inclusion of the following elements in the Constitution, namely:

- ◆ The establishment of a *Bundesrat* (Federal Council), consisting of representatives of the governments of the member states, as one of the two chambers of parliament; and
- ◆ A vertical division of powers between the Empire and the member states.<sup>17</sup>

The Constitution further provided that the legislative competences vested mainly in the *Reich*, while the constituent states would be responsible for the execution of federal laws since they all had existing administrations.<sup>18</sup> Except for federal functions, such as foreign relations, the federal navy and military affairs, no central administrative system was created since the individual states provided the system of administration for the *Reich*. Through prior agreement certain legislative and executive rights or competences (*Reservatrechte*) were excluded from the federal domain and allocated to the southern states of Bavaria, Württemberg and Baden.<sup>19</sup> The allocation of executive responsibility for federal legislation to the states was balanced by providing a supervisory authority over the execution of federal laws to

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<sup>15</sup> Lerche *Principles of German Federalism* in Kirchhof & Kommers (eds) *Germany and its Basic Law* (1993) 71; Kaufmann *Bundesstaat* 17.

<sup>16</sup> The *Verfassung des Deutschen Reichs* was put into operation on 4 May 1871. See Venter *Constitutional Comparison – Japan, Germany, Canada and South Africa as Constitutional States* (2000) 64; Kimminich *Deutsche Verfassungsgeschichte* 426.

<sup>17</sup> Laufer & Münch *Das föderative System* 40, 262.

<sup>18</sup> Laufer & Münch *Das föderative System* 42; Kilper & Lhotta *Föderalismus in der Bundesrepublik Deutschland* (1996) 47.

<sup>19</sup> Kimminich *Deutsche Verfassungsgeschichte* 433; Laufer & Münch *Das föderative System* 43.

the *Bundesrat*. The division of legislative and executive competences between the *Reich* and the states and the accompanying supervisory function of the *Bundesrat* resembles the current state of affairs in Germany. The Basic Law provides that the bulk of the administrative responsibility lies with the *Länder* and that the *Bundesrat* has a supervisory role regarding the execution of federal laws by the *Länder*.<sup>20</sup>

The formation of the *Reich* required specific arrangements regarding finances. The *Reich* was financially dependent on the states as they retained control over direct taxes, for example income tax and property tax. The main source of income for the *Reich* was customs duties and excise on tobacco, salt and sugar.<sup>21</sup> Bavaria, Württemberg and Baden retained control over beer taxes.<sup>22</sup> There was a clear need to have some form of equalisation arrangement amongst the *Reich* and the 25 states. This was provided for in the form of a per capita contribution from each state to the *Reich* and was called the “*Matrikular-Beiträge*”. In spite of the fact that the Constitution provided for the introduction of a new central tax administration for the *Reich*, it took more than thirty years before meaningful progress was made in this respect.<sup>23</sup>

The end of the First World War brought about a new phase in Germany’s constitutional development. In the wake of military defeat and the existence of opposing ideas, such as those supporting the creation of a unitary German state dominated by Prussia and the federalist views held by the southern states, a new constitution had to be drafted. The continued search for a united Germany and a democratic system of government also influenced this debate. Eventually the National Assembly in Weimar adopted a proposal for a new constitution that created a democratic and decentralised system of government.<sup>24</sup> The essence of the Weimar Constitution was a move away from monarchies and semi-independent states under the German Empire, to a parliamentary system of government where the balance of

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<sup>20</sup> See Art 30, 83, 84 Basic Law; Sachs *Grundgesetz Kommentar* (1996) 1350 - 1356.

<sup>21</sup> Bundesministerium der Finanzen *Unsere Steuern von A-Z* (1997) 13.

<sup>22</sup> Kimminich *Deutsche Verfassungsgeschichte* 433.

<sup>23</sup> In 1906 a number of *Reichssteuern* (federal taxes) was imported into the system. Laufer & Münch *Das föderative System* 42.

<sup>24</sup> The Secretary of State for Internal Affairs, who was also a public law professor, Hugo Preuss, provided the National Assembly in Weimar with a proposal for a new constitution, which came into operation on 11 August 1919. For a detailed discussion on the Weimar Constitution see Kimminich *Deutsche Verfassungsgeschichte* 484 - 505; Laufer & Münch *Das föderative System* 46 – 52.



power shifted towards the federal government. The adoption of the Weimar Constitution caused a shift of power from the constituent states, or *Länder* as they were now called, to the federal level of government.<sup>25</sup>

An organ called the *Reichsrat*, which was the representative organ of the *Länder* in federal legislative and administrative matters, replaced the *Bundesrat* as second chamber in the federal parliament.<sup>26</sup> The composition and status of the *Reichsrat* differed from that of its predecessor. The *Länder* were represented by members of their respective governments or by their delegates, while the size of their representation depended on a formula based on the number of inhabitants in each Land. In view of its size, Prussia dominated the decision-making in the *Reichsrat*, as it did in the previous *Bundesrat*. The Weimar Constitution stipulated that no Land may hold more than two fifths of the votes in the *Reichsrat*.<sup>27</sup> The *Reichsrat* had far less influence in federal legislation than the *Bundesrat* had under the German Empire. While the previous *Bundesrat* had full veto over legislation, the *Reichsrat* only had a suspensive veto. Under the 1871-Constitution federal legislation could only be adopted when both chambers, the *Reichstag* and the *Bundesrat*, agreed. Thus the *Bundesrat* had full veto over legislative proposals from the *Reichstag*.<sup>28</sup> In terms of the Weimar Constitution a no-vote by the *Reichsrat* could only suspend the legislative process, as its decision could be defeated by a two-thirds majority vote in the *Reichstag*. The Federal President could still proclaim the law or call a referendum.<sup>29</sup>

The *Länder* were responsible for the administration of federal laws, while the Weimar Constitution went a step further in centralising power to stipulate that federal legislation may provide otherwise. The federal government had a duty to oversee the effective performance of the *Länder* in this respect and could give directions to the *Länder* on the execution of federal laws.<sup>30</sup>

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<sup>25</sup> Kaufmann *Bundesstaat* 18.

<sup>26</sup> Art. 60 – 66 Weimar Constitution.

<sup>27</sup> Art. 63 Weimar Constitution; Laufer & Münch *Das föderative System* 48.

<sup>28</sup> Laufer & Münch *Das föderative System* 40.

<sup>29</sup> Laufer & Münch *Das föderative System* 49.

<sup>30</sup> Art 14, 15 Weimar Constitution; Currie *The German Constitution* 5; Kilper & Lhotta *Föderalismus* 49; Laufer & Münch *Das föderative System* 48.

A major shift in financial competences occurred under the Weimar Constitution. The *Länder* lost their taxing powers in favour of the *Reich*, that received the legislative competence over major taxes, namely income tax, corporate tax, sales tax, inheritance tax and property transfer tax.<sup>31</sup> The shift of legislative competences from the *Länder* to the *Reich* was complemented by this shift in financial competences. The national debt caused by World War I and the cost of rebuilding the country were the main reasons for centralising fiscal competences and creating a financial administration at federal level that was established on 1 October 1919.<sup>32</sup> As a result of this radical change in the financial intergovernmental relations in the Weimar Republic, the *Länder* became dependent on the *Reich*. In this way the *Reich* created a financial system through which it could maintain the functioning of the state administration in the *Länder*.<sup>33</sup> The *Länder*, and through it also the *Gemeinden* (local government), received a fixed percentage of the taxes raised by the *Reich*. In addition to this federal allocation, the *Länder* and the *Gemeinden*, retained some indirect taxes such as taxes on trade, fixed property and buildings.

During the time of the Weimar Republic essential federal issues, such as the relationship between the *Reich* and the *Länder* and the function of the *Reichsrat*, were under the spotlight on various occasions, for example at the *Länderkonferenz* in January 1928.

With the rise of National Socialism (Nazism) in Germany in the 1930's, it was clear that the particular constitutional order of the Weimar Republic did not quite fit into the new authoritarian ideology. The take-over of power by the National Socialist Party caused the elimination of all traces of federalism in Germany. The appointment of national socialist *Reichskommissäre* in the *Länder* not governed by the National Socialist Party, the dissolution of the *Länder* parliaments and the eventual removal of the *Reichsrat*, substantiate this fact.<sup>34</sup> The end of the federal system in 1934 also marked the end of democracy in Germany. It was a dark period in German history and lasted until 1945 with the end of World War II, when the German forces

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<sup>31</sup> Art 11 Weimar Constitution; Laufer & Münch *Das föderative System* 50.

<sup>32</sup> Laufer & Münch *Das föderative System* 49.

<sup>33</sup> Kilper & Lhotta *Föderalismus* 49.

<sup>34</sup> Laufer & Münch *Das föderative System* 52; Kaufmann *Bundesstaat* 22.

capitulated and the Western allied powers, namely France, Britain, and the United States of America, together with the Soviet Union occupied Germany.<sup>35</sup>

In the aftermath of the war, a strong view in favour of a federal system developed regarding Germany's constitutional future, in particular in the part that was controlled by the three allied powers. An important step in the constitutional debate was the presentation of the so-called *Frankfurter Dokumente*, by the three military governors of the Western occupied zones, to the governments of these zones on 1 July 1948 in Frankfurt. These documents were the result of a conference held in London by the three Western occupation forces (USA, Britain and France) and included Belgium, Netherlands and Luxembourg. The documents laid the basis for the constitutional development of the Western zones and signified the separation of Germany into a Western allied state and a Soviet allied state, a step that had profound implications for the German people and for the constitutional development of Germany.<sup>36</sup> The *Frankfurter Dokumente* inter alia made provision for the establishment of a constitutional assembly that would be responsible for the drafting of a new constitution based on federal principles for the Western zones.<sup>37</sup>

The contents of the *Frankfurter Dokumente* were not fully acceptable to the 11 minister-presidents in the three zones as they wanted to develop only the administrative organization of the Western occupied zones and not to create a new smaller German state that would perpetuate the division of the country.<sup>38</sup> A compromise was made in order to proceed with the constitutional process. This compromise ensured that the terms “parliamentary council” in stead of “constitutional assembly”, and “*Grundgesetz*” in stead of “*Verfassung*” would be used in the new constitution.<sup>39</sup> A first important step in establishing the parliamentary council was the

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<sup>35</sup> Frowein *Die Rechtslage Deutschlands und der Status Berlins* in Benda et al *Handbuch des Verfassungsrechts* (1983) 28 31.

<sup>36</sup> Hesse *Das Grundgesetz in der Entwicklung der Bundesrepublik Deutschland: Aufgabe und Funktion der Verfassung* in Benda et al *Handbuch des Verfassungsrechts* (1983) 3 7.

<sup>37</sup> There were three *Frankfurter Dokumente*, namely on the constitutional future of the western occupied zones, a new division of *Länder* and transitional provisions that provided the legal basis for the military governors and the proposed new *Länder* governments.

<sup>38</sup> Hesse *Das Grundgesetz in der Entwicklung der Bundesrepublik Deutschland* 7.

<sup>39</sup> The minister-presidents were seriously concerned that the terminology proposed by the military governors, namely *Verfassungsgebende Versammlung* and *Verfassung*, sealed the division of Germany while there was still a possibility, although remote, of one Germany. They therefore suggested a softer approach, namely to use the terms *Parlamentarischer Rat* and *Grundgesetz* instead. Kilper and Lhotta

Herrenchiemsee constitutional convention, a meeting of 26 constitutional experts instructed by the minister-presidents of the Western zones to develop a draft constitutional proposal to be discussed in the parliamentary council. The meeting was tasked with negotiating and drafting of the constitution.

The three most contentious issues debated in the parliamentary council were:

- ◆ the composition and competence of the second chamber of the German parliament;
- ◆ the division of financial legislative and administrative competences between the *Bund* and the *Länder*; and
- ◆ the division of the tax income between the *Bund* and the *Länder*.

These issues are central to the federal character of the new West German state. The *Länder*, that existed at the time of drafting the Basic Law, played an important role in the shaping of this new constitution. After much debate regarding the second chamber of the federal level, a choice was made in favour of a *Bundesrat*. This clearly resembled the *Bundesrat* in the German Empire of 1871 and consisted of representatives of the *Länder* governments. It did not receive equal powers to the *Bundestag*, the popularly elected chamber, but had a suspensive veto over ordinary legislation and full veto over constitutional amendments and matters affecting the *Länder*. The *Länder* remained responsible for the bulk of the administration of federal laws.

The division of the Western occupied zones into *Länder* followed partly historical lines and was partly newly created regions. Berlin, which was divided into allied and soviet occupied zones after the War, continued to be so until 1990. West Berlin was regarded as a *Land* within the Federal Republic of Germany and participated as such in the constitutional order of the Federal Republic, while East Berlin was part of the German Democratic Republic.<sup>40</sup>

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*Föderalismus* 81; Dolzer *The Path to German Unity: The Constitutional, Legal and International Framework* in Kirchhof & Kommers (eds) *Germany and Its Basic Law* (1993) 365 370.

<sup>40</sup> Frowein *Die Rechtslage Deutschlands und der Status Berlins* 54.

**Table 2 1: The *Länder* in the Western Zones in 1947**

The American Zone

Bavaria  
Bremen  
Hessen  
Württemberg-Baden

The British Zone

Hamburg  
Lower Saxony  
North-Rhine Westphalia  
Schleswig-Holstein

The French Zone

Baden  
Rheinland-Palatinate  
Saarland  
Württemberg-Hohenzollern<sup>41</sup>

The debate regarding the financial issues proved difficult to solve. Eventually due to pressure from the Allied Forces, a compromise was reached in the parliamentary council about the financial constitution, or *Finanzverfassung* as it is referred to in German literature. This implied that the financial administration would be shared between the *Bund* and the *Länder* and the legislative competence over taxes would be divided between the *Bund* and the *Länder*. While the *Bund* received the legislative competence over the major taxes such as personal income tax and corporate tax, the *Länder* through the *Bundesrat* had an equal say in the adoption of federal tax legislation. Another important element of this constitutional compromise was the provision for financial equalisation, or *Finanzausgleich*, in order to provide a

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<sup>41</sup> On 9 December 1951 a new Land, namely Baden-Württemberg which included the *Länder* Baden, Württemberg-Baden and Württemberg-Hohenzollern, came into existence.

mechanism through which the principle of *Einheitlichkeit der Lebensverhältnisse* (uniformity of living standards) could be promoted.<sup>42</sup>

On 8 May 1949 the majority of the parliamentary council voted in favour of the text of the new constitution, and between 18 and 21 May 1949 eleven of the twelve *Länder* parliaments (*Landtage*) voted in favour of the text.<sup>43</sup> The adoption of the new constitution, *Grundgesetz*, signified the end of a dark chapter in Germany's history and gave birth to the modern day Germany, that was divided into a western (Federal Republic of Germany) and eastern part (German Democratic Republic) until 1990 when unification took place.<sup>44</sup>

The Treaty of Unification (*Einigungsvertrag*) of 31 August 1990 stipulated the constitutional issues, in particular the amendments to the Basic Law, that were necessary to effect unification.<sup>45</sup> The *Deutsche Demokratische Republik* (DDR) ceased to exist on 3 October 1990 when the new Federal Republic of Germany that consists of sixteen *Länder* came into existence.

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<sup>42</sup> Kilper & Lhotta *Föderalismus* 96–98, Laufer & Münch *Das föderative System* 67. See discussion in **Chapter 5**.

<sup>43</sup> The parliamentary council voted 53 in favour and 12 against the text, while all the *Landtage* except Bavaria supported it. The argument of the majority in the Bavarian *Landtag* was that the new constitution was not federal enough. They, however, recognised the legality of the *Grundgesetz*. Kaufmann *Bundesstaat* 42, Kilper & Lhotta *Föderalismus* 98.

<sup>44</sup> On 23 May 1949, when the *Grundgesetz* was signed by the Minister-presidents of the western *Länder*, the Federal Republic of Germany was born. Later that year the constitutional debate in the eastern zones led to the adoption of a constitution for the German Democratic Republic, which came into existence on 7 October 1949.

<sup>45</sup> The *Vertrag zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik über die Herstellung der Einheit Deutschlands* was adopted by the *Bundesrat* and the *Bundestag* as well as by the *DDR-Volkskammer*. It inter alia provided that the newly created *DDR-Länder* would become *Länder* of the new Federal Republic of Germany.

**Table 2 2: *Länder* and votes in the *Bundesrat* after unification in 1990<sup>46</sup>**

<b>Land</b>	<b>Votes</b>	<b>Land</b>	<b>Votes</b>
Bavaria	6	Saxony	4
Baden-Württemberg	6	Saxony-Anhalt	4
Lower Saxony	6	Schleswig-Holstein	4
North-Rhine Westphalia	6	Thuringia	3
Hessen	5	Bremen	3
Berlin	4	Hamburg	3
Brandenburg	4	Mecklenburg-Western Pomerania	3
Rhineland-Palatinate	4	Saarland	3

## **2 1 2 Fundamental principles of German constitutional system**

For a clear understanding of the German constitutional system, including the system of financial intergovernmental relations, a discussion of the fundamental principles in the Basic Law is essential.

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<sup>46</sup> Laufer & Münch *Das föderative System* 82.

There are four fundamental principles on which the constitutional order as described in the Basic Law is based. These are the principles of a democratic and social federal state based on a Rechtsstaat.<sup>47</sup> In addition, another fundamental principle is referred to in Article 23 of the Basic Law, namely the principle of subsidiarity. This is used in the context of the European Union and its relationship with the Federal Republic of Germany and its constituent units. It was not originally part of the Basic Law, but was included in an amendment of 12 December 1992.<sup>48</sup>

### **A democratic state**

Article 20 is one of the cornerstones of the Basic Law and contains the basic principles of the German constitutional order that provide the essential features of the system. It is protected against any constitutional amendments by the provisions of Article 79 (3).<sup>49</sup> Article 20 (1) states that

“[t]he Federal Republic of Germany shall be a democratic and social federal state.”

These principles are interrelated and all contribute to the constitutional composition of the Basic Law, however they can be distinguished within the context of the Basic Law.

Effect is given to the principle of a democratic state in a number of provisions in the Basic Law. Public authority, which emanates from the people, shall be exercised by way of elections and referenda, as stated in Article 20 (2).<sup>50</sup> The constitutional structures, such as the Federal Parliament that consists of the *Bundestag* and the *Bundesrat*, are also democratic in nature. Article 21 provides for the establishment and functioning of political parties. Everybody has the right to freedom of expression (Article 5) and freedom of association (Article 9), which are essential features of a

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<sup>47</sup> The official English translation of the Basic Law translates “Rechtsstaat” with “rule of law”.

<sup>48</sup> Würtenberger “The Principle of Subsidiarity as a Constitutional Principle” in Elwein et al (eds) *Jahrbuch zur Staats- und Verwaltungswissenschaft* 7 (1994) 65 66.

<sup>49</sup> Art. 79 (3) states: “Amendments to this Basic Law affecting the division of the Federation into *Länder*, their participation in the legislative process, or the principles laid down in Articles 1 and 20 shall be prohibited.”

<sup>50</sup> Dürig *An Introduction to the Basic Law of the Federal Republic of Germany* in Karpen (ed) *The Constitution of the Federal Republic of Germany* (1988) 18.



democratic state. Article 28 stipulates that the constitutional order in the *Länder* should also conform to the principles of “the republican, democratic and social state governed by the rule of law within the meaning of the Basic Law.” Article 28 further provides for elected governments in the *Länder*, districts and municipalities. This provision, often referred to as the homogeneity clause, extends the fundamental principles to the *Länder* in order to make the *Länder* constitutions fit within the framework of the Basic Law.

### **The *Rechtsstaat***

The principle of the *Rechtsstaat*, embodied in Article 20 (3) of the Basic Law, is regarded as one of the fundamental principles of the Basic Law and establishes the supremacy of the constitution.<sup>51</sup> An important element of a constitutional state is the recognition of the separation of powers, into the executive, legislative and judicial branches of government. This is given effect to in the Basic Law.<sup>52</sup> All pillars of government are bound by this provision, and are protected against constitutional amendment by Article 79 (3). This implies that the Basic Law is higher than any other law in the country and that any legislative, executive or judicial action may not be in contradiction to the provisions of the Basic Law. All positive law must conform to the values encapsulated in the Basic Law. The *Rechtsstaat* thus provides a formal and substantial limitation to the powers of the state.

The *Rechtsstaat* also includes the recognition and protection of human rights listed in the Basic Law (Articles 1 – 17) and acts as a guarantee for judicial review of administrative action as stipulated in Article 19 (4).<sup>53</sup> The strengthening of the *Rechtsstaat* provisions in the Basic Law when compared to the Weimar constitution is a reaction to the total disregard for the various elements of the *Rechtsstaat* during the National Socialist regime.<sup>54</sup> Although all branches of government are responsible for implementing the Basic Law, the courts have an important role as guardians of the

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<sup>51</sup> Benda *Der soziale Rechtsstaat* in Benda et al *Handbuch des Verfassungsrechts* (1983) 477 481.

<sup>52</sup> See for example Art 38 (*Bundestag*), Art 50 (*Bundesrat*), Art 62 (Federal Government) and Art 92 (Judiciary). Hesse *Das Grundgesetz in der Entwicklung der Bundesrepublik Deutschland* 18; Benda *Der soziale Rechtsstaat* 492.

<sup>53</sup> Kommers *The Constitutional Jurisprudence of the Federal Republic of Germany* (1997) 37; Currie *The Constitution of the Federal Republic of Germany* (1994) 19; Benda *Der soziale Rechtsstaat* 494.

<sup>54</sup> Hesse *Das Grundgesetz in der Entwicklung der Bundesrepublik Deutschland* 9.

Basic Law, in particular the Constitutional Court (*Bundesverfassungsgericht*) as the final arbiter in constitutional disputes.

### **The Social State (*Sozialstaat*)**

A bill of rights, including social rights, is included in quite a few constitutions in the world. The Basic Law includes a limited provision for direct social rights, for example Article 6, that provides a right for the protection and support of mothers and the protection of children born outside of marriage. The drafters of the Basic Law included the concept of a social state as a fundamental principle in the Basic Law<sup>55</sup> and this places a duty on the state to act positively in pursuance of the general welfare of the people of the country.<sup>56</sup> It must be the aim of the state to create an environment where human dignity is protected. The inclusion of this principle in the Basic Law should be seen against the background of a country destroyed by World War II and the need for direct state involvement in the rebuilding of the economy as well as in the improvement of the general welfare of the public.

The social state principle does not create rights, but it creates a constitutional directive for the state.<sup>57</sup> It is regarded as a fundamental constitutional principle that indicates the particular character of the state, namely a social state and this implies that the state has a duty to care for its citizens. This principle can also assist in the interpretation and application of the Basic Law, for example, the application of the right to human dignity in Article 1.<sup>58</sup> There is a duty on both the legislative and the executive branches of government to promote public welfare, a duty that, for example, includes legislation and practical plans to provide adequate health care facilities for the public.

The social state principle is also entrenched in the context of the financial constitution. Article 106 (3) of the Basic Law lays down the important aim of the *Finanzausgleichsystem* (system of financial equalisation) to ensure “equal living conditions” in all of the *Länder*.<sup>59</sup> An underlying philosophy behind this aim is to have a basic standard of services provided by the state throughout the federal territory.

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<sup>55</sup> Art. 20 (1) of the Basic Law.

<sup>56</sup> Currie *Constitution of Germany* 21.

<sup>57</sup> Benda *Der soziale Rechtsstaat* 510.

<sup>58</sup> Sachs *Grundgesetz Kommentar* (1996) 629–630.

<sup>59</sup> Lerche *Principles of German Federalism* 71–79.

Although there is a formula involved in the *Finanzausgleichsystem* and it thus has a mechanistic element, one can argue that financial equalisation is an application of the social state principle.<sup>60</sup>

### **The Federal State (*Bundesstaat*)**

The name “Federal Republic of Germany” (*Bundesrepublik Deutschland*) already indicates that the country has a federal constitutional structure. This notion is further embedded in the Basic Law as one of the fundamental principles that can never be amended.<sup>61</sup> In Article 20 (1) it is stipulated that the Federal Republic of Germany is a federal state (*ein Bundesstaat*). The principle of a federal state includes the structural division of the country into *Länder* (the member states) and the *Bund* (the central or national state). Due to the fact that this principle is protected absolutely in the Basic Law, the constitutional division of the country into *Länder* and the *Bund* may never be amended.<sup>62</sup>

The federal state principle further includes a constitutional division of functions between the various constituent units (Articles 70 – 82). The *Länder* have constitutionally allocated powers, for example, they participate in the federal legislative process through the *Bundesrat* (Articles 50 – 51) and the *Bund* has a duty towards the *Länder* (Article 28 (3)). The *Länder*, that have own legislative, executive and judicial institutions, thus have a certain “state quality” and can not be seen as administrative extensions of the *Bund*.<sup>63</sup> The constitutional order in the *Länder* must adhere to the fundamental principles of the republican, democratic and social state governed by the rule of law.<sup>64</sup> Article 79 (3) guarantees the participation of the *Länder* in the legislative process, and implies that they should have some constitutionally allocated legislative competence of their own. It further implies that the *Länder* should also take part in the federal legislative process.<sup>65</sup>

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<sup>60</sup> This will be discussed in detail in **Ch 5**.

<sup>61</sup> Art. 79 (3) of the Basic Law.

<sup>62</sup> Laufer & Münch *Das föderative System* 84.

<sup>63</sup> Laufer & Münch *Das föderative System* 85; Kommers *Constitutional Jurisprudence* 75.

<sup>64</sup> Art 28 of the Basic Law.

<sup>65</sup> Dürig *Introduction to the Basic Law* 21. The division of functions will be discussed in detail in **Ch 4**.

An unwritten constitutional principle, that is arguably part of the federal state principle in the Basic Law, is *Bundestreue*, or federal loyalty of the constituent units towards the federal state. *Bundestreue* is an expression of the *Bundesstaat* principle that compels both the *Bund* and the *Länder* to federal-friendly conduct.<sup>66</sup> It does not only apply to the interaction between the *Bund* and the *Länder*, but also to the *Länder* amongst themselves.<sup>67</sup>

An important element of the federal state principle, and particularly in the context of this dissertation, is that there is a constitutional division of financial powers and functions between the *Bund* and the *Länder* (Articles 104 – 115). This is a core element of the German constitutional system.<sup>68</sup> The practical application of *Bundestreue* is quite evident when exercising financial powers and functions.<sup>69</sup> This underlines the overarching role of the federal state principle in the Basic Law.

The principle of a federal state suggests the creation of federal organs of state, and Germany is no exception. Without reducing the importance of the other federal institutions, two are quite relevant to the development of the financial constitution, which is an important focus of this dissertation. These two institutions are the *Bundesrat* and the *Bundesverfassungsgericht* (the Federal Constitutional Court). The *Bundesverfassungsgericht* is the highest court in the country and therefore has the final word in any constitutional dispute between organs of state, this includes disputes concerning the application of the financial constitution. The *Bundesrat*, being the federal legislative organ that represents the interests of the *Länder*, plays an important role in the federal legislative process, including the processes concerning financial legislation. It is through the *Bundesrat* that the *Länder* can influence federal tax matters and the division of federal revenue.

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<sup>66</sup> Bayer *Die Bundestreue* (1961) 126.

<sup>67</sup> Von Münch *Staatsrecht* (1993) 238; Bayer *Bundestreue* 126.

<sup>68</sup> The division of financial powers and functions is the subject of **Ch 4**.

<sup>69</sup> See e.g. the first *Financial Equalisation Case* (1952) *BVerfGE* 1, 117.

## 2 2 South African constitutional system

### 2 2 1 Historical overview

The first constitution for South Africa became operational on 31 May 1910, the official birth date of the Union of South Africa. The creation of this new country took place eight years after the signing of a peace treaty, the Treaty of Vereeniging. This treaty was entered into by the British Empire and the leaders of the two Boer republics, the Orange Free State and Transvaal (*Zuid-Afrikaansche Republiek*).<sup>70</sup> The signing of the peace treaty marked the end of the three-year long Anglo-Boer War, that was fought from 1899 – 1902. As a result of this treaty the two Boer republics came under the jurisdiction of the British Crown. The territory covered, and later known as South Africa, also included two British colonies, namely the Cape of Good Hope and Natal.

In the years following the end of the Anglo-Boer War debate in South Africa revolved around the need to establish a new country that would include the above-mentioned four territories. The debate addressed issues regarding the nature of the new state and the particular relationship between the then existing four territories and a new national government. The search for a new united South Africa culminated in the establishment of the South African National Convention in October 1908. It was clear from the start of these proceedings that the aim of the various participants was to establish a union and not a federal system of government.<sup>71</sup> Sir Henry de Villiers, President of the National Convention, referred to the search for a union of the self-governing colonies under the British Crown in his opening address on the first day of the National Convention.<sup>72</sup> The convention took place during 1908 and 1909 in

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<sup>70</sup> The Treaty of Vereeniging was signed in Pretoria on 31 May 1902 by Pres. S. W. Burger of the Transvaal, other members of his government, Acting Pres. C. R. de Wet of the Orange Free State, other members of his government and Lord Kitchener and Lord Milner, the two representatives of the British Government. For a detailed account of the negotiations and signing of the Treaty see Kestell & Van Velden *Die Vredesonderhandelinge* (1909).

<sup>71</sup> Ebrahim *The Soul of a Nation - Constitution-making in South Africa* (1998) 6 – 7; Wiechers *Staatsreg* (1981) 196.

<sup>72</sup> Hofmeyr *Minutes of Proceedings of the South African National Convention* (1911) 1.

Durban, Cape Town and Bloemfontein, and aimed to design a constitution for South Africa.<sup>73</sup>

The draft constitution produced by the National Convention was a form of constitutional agreement between the four territories. After approval of the draft by the four parliaments it was presented to the British Parliament for enactment.<sup>74</sup> The new country was a union under the British Empire and was thus an Act of the British Parliament, namely, the South Africa Act, 1909.<sup>75</sup> It is significant to note that, although the new union consisted of four previously self-governing territories that each had to pass a parliamentary resolution to join the union, the new constitution did away with all the old colonial structures and the Boer republics and created in their place a new framework of government. In terms of this, a new national government was created and subsequently provincial governments were established.<sup>76</sup> Prior to the National Convention there were some discussions between various political leaders regarding the nature of the future state, namely, whether it should follow a unitary or a federal constitutional model. General Jan Smuts, one of the prominent leaders at the time initially favoured a federal system but feared that an American style federal model could lead to civil war. He later changed his mind to favour a unitary system where there would be a strong central government, and suggested a model for a union (unitary system) of South Africa to the National Convention.<sup>77</sup>

The four territories became known as four provinces within the Union and retained some legislative and executive authority. Executive and legislative structures were created at the national level, but these institutions were still subject to the authority of the British Government. The division of power between the new provinces and the

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<sup>73</sup> The National Convention consisted of 33 delegates from the parliaments of the four territories and met between October 1908 and February 1909. See Hofmeyr *National Convention* v - xiv; Wiechers *Staatsreg* 198.

<sup>74</sup> In addition to the formal resolutions taken by the four parliaments, Natal also had a referendum on the question whether it should enter such a union in terms of the draft constitution. On 16 June 1908 an overwhelming majority of the voters supported a proposal to join the other three territories in the proposed union. See Hofmeyr *National Convention* vi.

<sup>75</sup> South Africa Act, 1909 (Edw VII c 9).

<sup>76</sup> Brand *The Union of South Africa* (1909) 54.

<sup>77</sup> Davenport *South Africa: A Modern History* (1987) 245; Thompson *The Unification of South Africa 1902 – 1910* (1959) 105.

Union resulted in an overwhelming weight of authority that vested in the Union.<sup>78</sup> The principle of parliamentary sovereignty became the basis of the South African constitutional system that developed since 1910. This principle is in contrast to the principle of supremacy of the constitution that became the fundamental basis of the South African constitutional system in 1994.

South Africa became independent from the British Crown in 1961 when the Republic of South Africa was established on 31 May 1961.<sup>79</sup> At this time South Africa was a racially divided country where non-white people did not have the right to vote. A system of apartheid, or separate development, for the different race groups was implemented by way of a range of specific legislation, for example the Natives Land Act of 1913 and the Promotion of Bantu Self-Government Act of 1959. The South African Parliament adopted the Constitution of the Republic of South Africa, Act 32 of 1961, but it was never the supreme law of the country because the principle of parliamentary sovereignty was dominant. The 1961-Constitution, like the South Africa Act, did not establish a federal system of government, but rather a unitary system in which the four provinces were subordinate to the national level of government. The provinces each had an elected provincial council with limited legislative authority, while their executive consisted of an administrator and an executive council. The 1961-Constitution provided for a two-chamber parliament that consisted of a national assembly and a senate. The executive branch of government consisted of a state president, a prime minister and a cabinet appointed by him. The judiciary, which was nationally organised and appointed, formed the third branch of government.

It took more than twenty years after South Africa's independence from Britain for major constitutional changes to be introduced. During this time more and more voices for major changes to South Africa's constitutional system were heard, both from within and from outside the country. In an attempt to extend democracy to non-white people, Parliament adopted a new Constitution in 1983. This introduced a new

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<sup>78</sup> Brand *The Union of South Africa* 53.

<sup>79</sup> A referendum was conducted in 1960 on the question of independence from Britain and the majority of voters elected to establish an independent republic. See Wiechers *Staatsreg* 212.

tri-cameral system to South Africa and was based on the policy of self-determination for the various population groups.<sup>80</sup>

It made provision for a three-chamber parliament, namely the Assembly (for whites), the House of Representatives (for coloureds) and the House of Delegates (for Indians).<sup>81</sup> Still no provision was made for black people to vote and the system was still based on race. The tri-cameral system introduced the concept of own affairs (for each population group) and general affairs (matters of common interest to everybody). The respective Houses of Parliament each had legislative competence for its own affairs and they shared the responsibility for general affairs. The 1983-Constitution established a President's Council that acted both as an advisory body and as arbitrator to rule on disputes between the Houses of Parliament.<sup>82</sup> Each of these Houses of Parliament had a ministers council that acted as executives for the own affairs of that particular population group. In addition there was a national cabinet chaired by the state president.<sup>83</sup> There was no provision for a prime minister.

Under the 1983-Constitution South Africa was still a centralised unitary state, although provision was made for the continued existence of the four provinces (Cape of Good Hope, Natal, Transvaal and the Orange Free State) and the division of functions for different population groups. Power, including the taxing power, was still concentrated in the national government and the typical features of a federation were absent. The provincial councils were abolished in 1986.<sup>84</sup> It should be noted that the 1983-Constitution was not the supreme law of the country and that the principle of parliamentary sovereignty still applied.<sup>85</sup> The constitutional system was highly centralised in respect of whites, coloureds and Indians, while attempts were made to decentralise and devolve power to blacks.<sup>86</sup> The policy of the South African Government during the seventies and eighties included the devolution of power to some of the black ethnic groups by way of establishing so-called homelands, some of

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<sup>80</sup> The Constitution of the Republic of South Africa, 1983 (Act 110 of 1983) was approved on 23 September 1983. See Booysen & Van Wyk *Die '83-Grondwet* 24.

<sup>81</sup> Sec 37 of Act 110 of 1983; Booysen & Van Wyk *Die '83-Grondwet* 95.

<sup>82</sup> Booysen & Van Wyk *Die '83-Grondwet* 109, 127.

<sup>83</sup> Sec 19 – 21 of Act 110 of 1983.

<sup>84</sup> It was abolished by the Provincial Government Act 69 of 1986.

<sup>85</sup> Booysen & Van Wyk *Die '83-Grondwet* 40.

<sup>86</sup> Van Wyk *Introduction to the South African Constitution* in Van Wyk et al (eds) *Rights and Constitutionalism - The New South African Legal Order* (1994) 133.



which received “independence” from South Africa (Transkei, Bophuthatswana, Venda and Ciskei) and others which received a more limited form of self-rule. A practical consequence of this was that black people could not vote for South Africa’s Parliament. It was clear that the 1983-Constitution did not create an all-inclusive democracy for South Africa, but it was a transitional step in South Africa’s constitutional development.<sup>87</sup> Under the Westminster system of government in South Africa, the doctrine of parliamentary supremacy led to no constitutional checks or limitations on the exercise of the power of the South African Parliament. This meant that the system, characterised by parliamentary supremacy, made it easier for apartheid to be implemented.<sup>88</sup>

Political violence in South Africa increased during the eighties and more demands were made for drastic changes to the constitutional system. A constitutional democracy that included all the people of South Africa and which made provision for the recognition and protection of human rights was being demanded. Economic, diplomatic, cultural and sport sanctions were implemented against South Africa by a number of countries. By the beginning of the last decade of the twentieth century, it was clear that South Africa was in dire need of radical reform and that it had to be done sooner rather than later. At this time, world politics changed dramatically with the fall of the Berlin Wall in November 1989 and the collapse of the Soviet Union. These events undoubtedly contributed to the climate for constitutional change in South Africa.

Without detracting from the important role that individuals, organisations and political parties played in the constitutional negotiations in the early nineties, there were two leaders with vision who were the main actors that contributed to South Africa’s “peaceful revolution” during the first half of the nineties. These are F. W. de Klerk, State President of South Africa and leader of the National Party, and Nelson Mandela, leader of the major political movement outside Parliament, the African

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<sup>87</sup> In *Executive Council, Western Cape Legislature and Others v President of the Republic of South Africa and Others* 1995 4 SA 877 (CC); 1995 10 BCLR 1289 (CC) para 7 the Court stated that the challenge was to change from an authoritarian system under strong central government to a constitutional system “establishing a constitutional State based on respect for fundamental human rights, with a decentralised form of government...” This was achieved by the 1993-Constitution.

<sup>88</sup> Currie & De Waal *The New Constitutional and Administrative Law* Vol I (2001) 50.

National Congress (ANC). Both played key roles in the constitutional negotiations between 1990 and 1993. Mandela eventually became South Africa's first democratically elected President in 1994 and De Klerk became one of two Deputy-Presidents in a Government of National Unity.

The constitutional negotiating process consisted of various stages that included a National Peace Accord and "talks about talks" before the actual constitutional negotiations took place.<sup>89</sup> Various rounds of bilateral and multi-party negotiations took place during 1991 and 1992. Eventually in March 1993 the process received new impetus when a multi-party planning conference set up the Multi-Party Negotiating Process (MPNP).<sup>90</sup> The result of this process was an agreement that there will be a two-phase constitution drafting process, namely that a first or interim constitution would be drafted by the MPNP and that the next phase would be an election for a new parliament. This would act as a constitutional assembly and would draft the so-called final constitution. In November 1993 the MPNP accepted a draft constitution with sufficient consensus and Parliament debated and formally adopted it in December 1993.<sup>91</sup>

The constitutional concepts of regionalism and federalism were tainted by the failure of and discriminatory nature of separate development under the system of apartheid.<sup>92</sup> During the constitutional negotiations various political parties held different views regarding the constitutional needs of South Africa, but it is safe to state that there were basically two main schools of thought. One supported a strong federal-type of system that included fairly autonomous provinces with substantial legislative and executive powers entrenched in the constitution. The main proponents of this view

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<sup>89</sup> A number of church, business and trade union leaders helped to create a climate of peace and stability within South Africa that was necessary for the further constitutional negotiation process. This led to the signing of the National Peace Accord in September 1991 by all the major political groupings in South Africa. De Klerk *The Process of Political Negotiation: 1990 – 1993* in De Villiers (ed) *Birth of a Constitution* (1994) provides a concise overview of the main events that took place during this important period of South Africa's constitutional history.

<sup>90</sup> The MPNP consisted of a plenary meeting of all the parties, a negotiating council and seven technical committees. Ebrahim *Soul of a Nation* 150 – 152; De Villiers & Sindane *Managing Constitutional Change* (1996) 4 – 7.

<sup>91</sup> The Constitution of the Republic of South Africa, 200 of 1993, commenced on 27 April 1994 with the first democratic election for the whole of South Africa.

<sup>92</sup> De Villiers "A constitutional scenario for regional government in South Africa: the debate continues" in 1993 (8) *SAPR/PL* 86 90.

were the Inkatha Freedom Party (IFP), the Democratic Party (DP) and the National Party (NP) Government. In their submissions to the Multi-Party Negotiating Process in May 1993, these parties expressed the view that a federal constitutional model with strong provincial governments and power to raise taxes at national, provincial and local level should be designed for South Africa.<sup>93</sup> Prior to 1990, the NP was very critical of federalism, but it changed its views to support a federal-type of system or regionalism, as it was often referred to. In its submission to the Multi-Party Negotiating Process, the NP expressed its support for a constitutional model that would provide for three levels of government, each with “appropriate and adequate” legislative and executive powers and functions, that would be entrenched in the constitution.<sup>94</sup>

The other main school of thought supported regionalism in terms of which there would be regional governments (provinces) with constitutionally entrenched powers and functions and a strong national government that would have both concurrent functions with the provinces as well as overriding powers. In other words, a strong central government with provinces with concurrent powers over certain provincial issues. The African National Congress was the main supporter of this school of thought. While the ANC initially, in 1990, proposed a unitary form of government that would include some delegated powers for regional and local government, it has later, after a study visit to Germany in 1991, supported the idea of meaningful regional governments with constitutionally entrenched powers that would be exercised concurrently with that of the national government.<sup>95</sup>

The result of the constitutional negotiations at Kempton Park was a compromise that included a decentralised system of government consisting of three levels, namely a

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<sup>93</sup> DP *Submission to the Multi-Party Negotiating Process Technical Committee on Constitutional Issues* (13 May 1993); IFP *Submission to the Multi-Party Negotiating Process Technical Committee on Constitutional Issues* (18 May 1993).

<sup>94</sup> South African Government *Principles governing constitution making in South Africa – a discussion document* (12 May 1993) 2.

<sup>95</sup> ANC *Submission to the Multi-Party Negotiating Process Technical Committee on Constitutional Issues* (12 May 1993); De Villiers “A constitutional scenario for regional government” 93.

national government, nine provincial governments and local government.<sup>96</sup> Another important feature was the inclusion of a justiciable bill of rights<sup>97</sup> and the principle of supremacy of the constitution. It also included the following federal characteristics, namely:

- ◆ three orders of government;
- ◆ distribution of legislative and executive authority (sections 59 – 62, 126, Schedule 6);
- ◆ distribution of financial resources (sections 155 – 159);
- ◆ participation by provinces in the national legislative process (section 48); and
- ◆ a constitutional court that can be the final arbiter on constitutional disputes between governments (sections 98 – 100).

In view of the particular distribution of legislative and executive powers between the national and provincial governments and the distribution of financial resources, the constitutional system created by the 1993-Constitution can best be described as a hybrid system with both federal and unitary characteristics.<sup>98</sup>

The weight of legislative powers for taxation was vested in national government, while provinces were given a limited degree of own tax powers. In order to fulfil their constitutional duties, provinces needed to have other sources of income. This was provided for in the form of a constitutional guarantee of “an equitable share of revenue collected nationally”.<sup>99</sup> The division of revenue among the national government, provinces and municipalities was based on a formula that was stipulated in the Constitution and details had to be developed by the Financial and Fiscal Commission (FFC). The basic scheme of financial intergovernmental relations

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<sup>96</sup> Sec 124 of Act 200 of 1993 established the following nine provinces: Eastern Cape, Eastern Transvaal (later renamed to Mpumalanga), KwaZulu-Natal; Northern Cape; Northern Transvaal (later renamed as Northern Province and later as Limpopo), North West, Orange Free State (later renamed as Free State), Pretoria-Witwatersrand-Vereeniging (later renamed as Gauteng) and Western Cape.

<sup>97</sup> Ch 3 of Act 200 of 1993.

<sup>98</sup> Watts *Is The New Constitution Federal or Unitary?* in De Villiers (ed) *Birth of a Constitution* 75 86; see also discussion under **1 1**.

<sup>99</sup> Sec 155 of Act 200 of 1993; Basson *South Africa's Interim Constitution* (1995) 224- 226.

developed in the 1993-Constitution, including the concept of an equitable share, was continued in the 1996-Constitution.

An important element of the multi-party agreement reached at the MPNP at Kempton Park in 1993, was that the new constitution that would be drafted by the constitutional assembly should be tested against a set of 34 Constitutional Principles. In view of the importance of the agreement on these Constitutional Principles, it is referred to as a “solemn pact” between the negotiating parties and being “foundational to the new constitution”.<sup>100</sup> This created the framework within which the elected Constitutional Assembly had to work to draft a new text and it was also the yardstick against which the new Constitution had to be measured before the Constitutional Court would certify it.<sup>101</sup>

Two years after receiving submissions and negotiating a new constitutional text the Constitutional Assembly eventually adopted the Constitution of the Republic of South Africa, Act 108 of 1996, on 8 May 1996. In the first round before the Constitutional Court, the text did not fully comply with the requirements of the Constitutional Principles and it was referred back to the Constitutional Assembly. Despite the fact that a variety of issues were argued before the Constitutional Court, much attention was given to the particular relationship between the national and provincial governments. The non-compliance of the constitutional text to Constitutional Principle XVIII. 2 (the scope of provincial powers) was one of the reasons for the Court’s refusal to certify.<sup>102</sup> An amended text was adopted on 11 October 1996 in

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<sup>100</sup> *In Re: Certification of the Constitution of the Republic of South Africa*, 1996 1996 4 SA 744 (CC); 1996 10 BCLR 1253 (CC) (*First certification case*) para 15; Ebrahim *Soul of a Nation* 178; Van Wyk “’n Paar opmerkings en vrae oor die nuwe Grondwet” 1997 (60) THRHR 377 381; Basson *Interim Constitution* 365; De Villiers *The Constitutional Principles: Content and Significance* in De Villiers (ed) *Birth of a Constitution* 37 41.

<sup>101</sup> *First certification case* paras 16 – 18; Erasmus & De Waal “Die Finale Grondwet: Legitimiteit en Ontstaan” 1997 (1) *Stell LR* 31 41.

<sup>102</sup> *First certification case* para 471. Constitutional Principle XVIII.2: “The powers and functions of the provinces defined in the Constitution, including the competence of a provincial legislature to adopt a constitution for its province, shall not be substantially less than or substantially inferior to those provided for in this Constitution.”

accordance with the judgement in the *First certification case*, whereafter the Constitutional Court certified the new text on 4 December 1996.<sup>103</sup>

The essential structural features of the 1993-Constitution were retained in the new 1996-Constitution, however it was not a mere amendment to the former but rather a completely new text. The most important characteristics of the 1996-Constitution are:

- ◆ Supremacy of the Constitution<sup>104</sup>;
- ◆ A justiciable bill of rights<sup>105</sup>;
- ◆ Three spheres of government, namely national, provincial and local government<sup>106</sup>;
- ◆ A division of powers and functions among the three spheres of government<sup>107</sup>;
- ◆ Co-operative government as overarching guiding principle for intergovernmental relations<sup>108</sup>;
- ◆ A system of financial intergovernmental relations<sup>109</sup>; and
- ◆ A constitutional court as final arbiter in constitutional disputes between spheres of government<sup>110</sup>.

Specific provision is made for provincial and, to a limited extent, local representation in the national legislative sphere of government. The National Council of Provinces, modelled to a large degree on the German *Bundesrat*, was created as a second chamber of Parliament and was designed to act as a house where provincial interest is represented.<sup>111</sup> Provinces are represented by multi-party delegations of ten each. These ten consist of six permanent and four special delegates. Although provision is

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<sup>103</sup> *Ex parte Chairperson of the Constitutional Assembly: In re Certification of the Amended Text of the Constitution of the Republic of South Africa, 1996 1997 (2) SA 97 (CC) (Second certification case)* para 204; Ebrahim Soul of Nation 232 – 235.

<sup>104</sup> Sec 1,2 of Act 108 of 1996.

<sup>105</sup> Sec 7 – 39.

<sup>106</sup> Sec 40.

<sup>107</sup> Various provisions spread through the Constitution stipulate the detail of this division, e g sec 43, 44, 85, 104, 125, 142 – 145, 153, 156 and Schedules 4 and 5. See the discussion of the allocation of powers and functions to the various spheres of government in **Ch 4**.

<sup>108</sup> Sec 41.

<sup>109</sup> Sec 213 – 230.

<sup>110</sup> Sec 166 – 167.

<sup>111</sup> Sec 60; see discussion in **Ch 4**.

made for voting as a province on provincial matters, the practical realities of political party discipline and current support of political parties contribute to the fact that the National Council of Provinces has not yet developed to its full potential as a house representing provincial interest.

There was a deliberate change in wording from the 1993-Constitution to the 1996-Constitution in the description of the orders of government in an attempt to move away from the traditionally rigid hierarchical description of levels of government. The constitutional order is now formally described as consisting of three spheres of government, namely national, provincial and local government. This suggests some degree of autonomy for the different spheres.<sup>112</sup> Although government in South Africa consists of three spheres, the main emphasis in the 1996-Constitution, as well as in practice, is on the national government and provincial governments and their particular relationships. The functioning of these two spheres as well as their mutual relationship is an essential focus of this thesis.

## **2 2 2 Fundamental principles of the South African constitutional system**

The principles on which the South African constitutional system, as described in the 1996-Constitution, are based can be traced back to the 34 Constitutional Principles agreed to at the Multi-Party Negotiating Process in Kempton Park in 1993.<sup>113</sup> This groundbreaking agreement not only mapped the way for the next phase in constitution making, but also laid down fundamental principles for the new constitutional system. These Constitutional Principles can be divided into different categories according to the issues dealt with, namely:

- ◆ Supremacy of the constitution and the *Rechtsstaat*;
- ◆ Bill of rights issues;
- ◆ Separation of powers;

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<sup>112</sup> Sec 40.

<sup>113</sup> Schedule 4 to Act 200 of 1993; De Villiers *The Constitutional Principles – Content and Significance* in De Villiers (ed) *Birth of a Constitution* 37; Venter “Requirements for a new constitutional text: the imperatives of the constitutional principles” 1995 (32) *SALJ* 32 et seq.

- ◆ Structural elements of government, division of powers and the intergovernmental relationship;
- ◆ Financial intergovernmental relations;
- ◆ Creation of independent institutions supporting democracy;
- ◆ Neutrality of security forces; and
- ◆ Transitional arrangements.

Formally, the Constitutional Principles were repealed when the 1996-Constitution was promulgated, but it is clear that the spirit of these principles continues to exist. The Constitutional Court hinted at the future influence of the Constitutional Principles when it referred to them as “broad constitutional strokes on the canvas of constitution making in the future.”<sup>114</sup>

Section 1 of the 1996-Constitution contains the fundamental values on which the Constitution is based. These values are human dignity, equality and the promotion of human rights; non-racialism and non-sexism; supremacy of the constitution and the rule of law; regular elections based on universal adult suffrage and a multi-party system of democratic government to ensure accountability, responsiveness and openness. These founding principles form the value base of the Constitution and act as guidance to the interpretation of the Constitution.<sup>115</sup> In addition to these foundational values there is another set of principles in the Constitution that plays a crucial role in the new constitutional order in South Africa, namely the principles of co-operative government and intergovernmental relations.<sup>116</sup>

The values contained in section 1, due to their fundamental nature, should be less vulnerable to constitutional amendments and therefore deserve stricter protection than other provisions of the Constitution. Although not absolutely entrenched as the fundamental principles of the German Basic Law are, they do enjoy a high level of protection.<sup>117</sup> Only section 1 and section 74 (amendment clause) require a 75% majority of the members of the National Assembly and six provinces in the National

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<sup>114</sup> *First certification case* para 36; Van Wyk 1997 (60) *THRHR* 381.

<sup>115</sup> Malherbe “Die wysiging van die grondwet: die oorspoel-imperatief van artikel 1” in 1999 (2) *TSAR* 191.

<sup>116</sup> Sec 41. See discussion under **2 3**.

<sup>117</sup> Art 79 (3) of the Basic Law. See also the discussion under **2 1 2**.



Council of Provinces to agree to an amendment before it can be made.<sup>118</sup> Other constitutional amendments can be made using less strict requirements.

The foundational values in section 1 can be grouped into three “principles”, namely

- ◆ Supremacy of the constitution and the rule of law;
- ◆ Human rights; and
- ◆ Democracy.

### **Supremacy of the constitution and the rule of law**

This fundamental value is reiterated in section 2 where the supremacy of the Constitution is set beyond doubt. Any law or conduct inconsistent with the Constitution is invalid. The rule of law or the *Rechtsstaat* is an overarching characteristic of this Constitution. This provision provides the formal basis of constitutionalism in South Africa. It directs all state action, including the judiciary, the legislative and executive branches of government.

The concept of the *Rechtsstaat* as it was developed in German constitutional law is now also a cornerstone of the South African constitutional order. The South African Constitution contains the following main elements of a modern *Rechtsstaat*:

- ◆ Supremacy of the constitution;
- ◆ Equality before the law, distribution of authority and judicial control over the exercise of authority; and
- ◆ The constitutional protection of fundamental human rights.<sup>119</sup>

### **Human rights**

The first two fundamental values in section 1, namely “human dignity, the achievement of equality and the advancement of human rights and freedoms, and non-racialism and non-sexism”, are clearly human rights related values. A full chapter,

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<sup>118</sup> *First certification case* para 153.

<sup>119</sup> See Wiechers “Grondslae van die Moderne Rechtsstaat/Foundations of the Modern Rechtsstaat” in 1998 (61) *THRHR* 624 for a discussion of the *Rechtsstaat* with reference to the current South African constitutional order.

Chapter 2, on human rights is contained in the 1996-Constitution. It contains not only first and second generation rights, but also some socio-economic rights, such as the right to have access to adequate housing and the right to have access to health care services.<sup>120</sup> Further effect is given to human rights values by the establishment of three separate constitutional institutions, namely the Human Rights Commission, the Commission for the Promotion and Protection of the Rights of Cultural, Religious and Linguistic Communities and the Commission for Gender Equality.<sup>121</sup>

## **Democracy**

Section 1 starts by referring to South Africa as a democratic state and then lists a few elements of democracy, in particular it mentions elections and the way in which government functions. Every adult has the right to vote in regular elections and a constitutional guarantee is given for a multi-party system of government. This is not only inherent in a democracy, but also provides one of the checks on government that is required under constitutionalism. Provision for a multi-party system of government at least lays the basis for opposition parties to exist and to play an important role in keeping government on its toes.

The values that specifically relate to the way in which government should function, namely accountability, responsiveness and openness are not only stipulated in section 1, but are echoed in other provisions in the Constitution as well. One of these provisions that is central to the financial administration of all governments in the country is section 215, that requires that budgets and budgetary processes must promote accountability, transparency and effective financial management.

## **2 3 Co-operative federalism**

Both Germany and South Africa currently have decentralised systems of government that fall within the wide range of modern federal systems.<sup>122</sup> In the Basic Law this is very explicitly stated in the title of the document as well as in Article 20, where the

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<sup>120</sup> Sec 26 and 27.

<sup>121</sup> Sec 181.

<sup>122</sup> See discussion under **1 1 3**.

existence of a federal state is determined. The fact that there are different levels of government is supported by other provisions of the Basic Law as well, such as Article 28 (federal guarantee of Land constitutions and local government) and Article 79 (3) (absolute protection of the division of the Federation into *Länder*).

In the case of South Africa, the description of the nature of the system of government is not so explicitly formulated as in the Basic Law, but various provisions of the 1996-Constitution contribute to the formulation of the South African constitutional system. Section 40, describes government in South Africa as “national, provincial and local spheres of government, which are distinctive, interdependent and interrelated.” This is a clear indication of a decentralised system of government. Detailed provisions on provincial and local government and the distribution of legislative and executive competences among the three spheres further supports the notion of a decentralised system of government.<sup>123</sup>

As noted before in the introductory part of this study, Wheare’s view of federalism is rather narrow and perhaps outdated. He described essentially a system of competitive federalism, where the different levels of government function independently from one another.<sup>124</sup> In this definition, no space is left for co-operation between the different levels of government. Elazar, on the other hand, stated that federalism includes a commitment to partnership and co-operation as well as respect for the integrity of each constituent unit.<sup>125</sup> This is particularly true about modern federal systems, the scope of which includes a variety of organisational arrangements. In fact, the scope of federal arrangements is so wide that one can perhaps argue that each federal system is *sui generis*.

According to De Villiers federalism includes “a civil and political culture that is simultaneously conducive to power-sharing and to autonomy, exhibits a tolerance towards diversity and experimentation, and provides for a managerial style that respects and cherishes the importance of co-operation and consultation between

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<sup>123</sup> Eg sec 44, 104, 156 and Schedules 4 and 5.

<sup>124</sup> Wheare *Federal Government* (1956) 11.

<sup>125</sup> Elazar *Federalism: an Overview* 2.

different levels of government.”<sup>126</sup> This is in addition to the legal framework provided in a constitution.

Simeon's recent discussion on the categories of modern federal systems where he distinguishes between two models, namely the divided federal model and the integrated federal model, provides a useful basis for discussions regarding current federal systems.<sup>127</sup> In terms of his analysis, Canada is a good example of the divided model. Germany, on the other hand, is perhaps the best example of an integrated or co-operative federal system.<sup>128</sup> The specific allocation of powers to the different spheres of government in a particular constitutional system gives rise to the question about the interaction between the various spheres. In other words, how do they relate to or interact with each other? Practical necessity often dictates that the various constituent units co-operate with each other in executing their duties as governments.<sup>129</sup> In the case of both Germany and South Africa, it is evident that the particular constitutional design requires co-operative behaviour between the various constituent units. South Africa's constitutional system, with its emphasis on concurrency and co-operative government, clearly relates to the co-operative or integrated federal model.<sup>130</sup>

The federal state principle in the Basic Law, referred to under **2 1 2**, includes the way in which the *Bund* and the *Länder* interact with each other. Due to the particular division of functions between these two spheres of government and the participation of the *Länder* in the federal legislative process, co-operation is a practical necessity. The principle of *Bundestreue*, which is essential to co-operative federalism, describes the relationship between the *Bund* and the *Länder*.

*Bundestreue* is defined by De Villiers as

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<sup>126</sup> De Villiers *Bundestreue: The Soul of an Intergovernmental Partnership* in *Occasional Papers* (March 1995) 4.

<sup>127</sup> Simeon "Considerations on the design of federations: the South African constitution in comparative context" 1998 (13) *SAPR/PL* 42 50.

<sup>128</sup> Simeon 1998 (13) *SAPR/PL* 55.

<sup>129</sup> *First Certification Case* para 290.

<sup>130</sup> Simeon 1998 (13) *SAPR/PL* 68. See also discussion of federal issues under **1 1 3**.

“the duty of national and regional governments within a federal state to take each other’s interests into account in the exercise of their respective responsibilities.”<sup>131</sup>

An essential element of this principle is mutual trust and respect between the respective governments within the federal state. Although not stipulated explicitly in the Basic Law, *Bundestreue* is a fundamental principle of the German constitutional system. It has its origin in the Constitution of the German Empire of 1871. When the southern states joined the North German *Bund* to form the German Empire agreements or treaties were concluded between them. These treaties were based on *Vertragstreue* or treaty trust.<sup>132</sup> The principle of *Bundestreue* was not explicitly described in the 1871-Constitution, but formed part of the unwritten constitutional law of Germany.

The German Constitutional Court, *Bundesverfassungsgericht*, was instrumental in developing *Bundestreue* as a significant constitutional principle in modern Germany. It is recognised as a fundamental unwritten constitutional norm (*Verfassungsnorm*) that places a duty on both the *Bund* and the *Länder* to act in good faith towards each other in a friendly relationship (*Pflicht zu bundesfreundlichen Verhalten*).<sup>133</sup> *Bundestreue* is the glue that binds the *Bund* and the *Länder* in a federal intergovernmental relationship. The *Bundesverfassungsgericht* in one of its first cases concluded that this unwritten constitutional principle of *Bundestreue* governs the relations between the *Bund* and the *Länder* as well as between the respective *Länder*. It implies a constitutional obligation on both the *Bund* and the *Länder* that is essential for the effective functioning of the constitutional arrangements under the Basic Law.<sup>134</sup>

Apart from the *Bundesrat* and other intergovernmental institutions where the *Länder* co-operate with each other, or with the *Bund* as the case may be, *Bundestreue* is of particular importance in the development of the financial constitution of Germany. In

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<sup>131</sup> De Villiers *Bundestreue* 6.

<sup>132</sup> De Villiers *Bundestreue* 10.

<sup>133</sup> De Villiers *Bundestreue* 15; Laufer & Münch *Das föderative System* 94.

<sup>134</sup> *BVerfGE* 1, 299 315; De Villiers *Bundestreue* 15, Laufer & Münch *Das föderative System* 95.

a federal system where there is an uneven distribution of resources, both vertically and horizontally, it is essential that the various governments interact with each other in a spirit of mutual trust and respect. Article 107 of the Basic Law lays down the basis for financial equalisation and inter alia requires the consent of the *Bundesrat* to pass a federal law on financial equalisation. Clearly, *Bundestreue* plays a central role in this instance. The *Bundesverfassungsgericht* realised this in an early decision on financial equalisation when it concluded that

“the equalisation statute would offend the federal principle if it would weaken the [financial] capacity of the contributing states or lead to a financial levelling of the states.”<sup>135</sup>

In the development of South Africa’s new constitutional order, attention was already given to intergovernmental relations at the Multi-Party Negotiating Process in 1993. A number of the Constitutional Principles agreed to in this process provided the framework for the future constitutional design of intergovernmental relations in South Africa. It was perhaps not realised at the time, but the seed of *Bundestreue* was planted at this point. Constitutional Principle XXII for example stipulated that

“The national government shall not exercise its powers (exclusive or concurrent) so as to encroach upon the geographical, functional or institutional integrity of the provinces.”<sup>136</sup>

An important difference between the 1993-Constitution and the 1996-Constitution is the fact that in the 1993-Constitution nothing was said about the way the three levels of government had to interact with each other. However, in the 1996-Constitution the position changed and in fact a separate chapter on cooperative government and intergovernmental relations was included, making it clear that the South African constitutional system is characterised by a cooperative relationship among the three spheres of government.

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<sup>135</sup> *BVerfGE* 1, 117 131; De Villiers *Bundestreue* 17; Kommers *Constitutional Jurisprudence* 91.

<sup>136</sup> Schedule 4 of Act 200 of 1993.

The influence of German constitutional law on the shape of South Africa's new constitutional system was quite strong, in particular in the period between 1994 and 1996 when the Constitutional Assembly designed the current Constitution. This is evident, for example, in the provisions that established the National Council of Provinces and the allocation of exclusive and concurrent legislative and executive powers to the various spheres of government. In view of the legal imperative of the Constitutional Principles, provision had to be made in the 1996-Constitution for specific provisions governing intergovernmental relations. The principle of *Bundestreue*, as it has developed in German constitutional law, was used as the foundation for the inclusion of chapter 3 of the 1996-Constitution on principles of co-operative government and intergovernmental relations.<sup>137</sup> This set of principles is foundational to the functioning of South Africa's constitutional system. The Constitutional Court confirmed that it was appropriate to co-operative government.<sup>138</sup>

The 1996-Constitution creates various centres of competence within the constitutional order. The reference to three spheres of government in section 40 not only indicates a move away from a traditional hierarchical structure, but also suggests some form of constitutional autonomy that recognises the integrity of each sphere of government. This is confirmed by the principles of co-operative government and intergovernmental relations listed in section 41 (1), namely:

- “All spheres of government and all organs of state within each sphere must –
- (a) preserve the peace, the national unity and the indivisibility of the Republic;
  - (b) secure the well-being of the people of the Republic;
  - (c) provide effective, transparent, accountable and coherent government for the Republic as a whole;
  - (d) be loyal to the Constitution, the Republic and its people;
  - (e) respect the constitutional status, institutions, powers and functions of government in other spheres;

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<sup>137</sup> Eight principles of co-operative government and intergovernmental relations are included in sec 41 (1) of Act 108 of 1996; Haysom *Federal Features of the Final Constitution* in Andrews & Ellmann *The Post-Apartheid Constitutions* (2001) 504 514.

<sup>138</sup> *First Certification Case* para 289.

- (f) not assume any power or function except those conferred on them in terms of the Constitution;
- (g) exercise their powers and perform their functions in a manner that does not encroach on the geographical, functional or institutional integrity of government in another sphere; and
- (h) co-operate with one another in mutual trust and good faith by –
  - (i) fostering friendly relations;
  - (ii) assisting and supporting one another;
  - (iii) informing one another of, and consulting one another on matters of common interest;
  - (iv) co-ordinating their actions and legislation with one another;
  - (v) adhering to agreed procedures; and
  - (vi) avoiding legal proceedings against one another.”

These principles are applicable to all intergovernmental relationships, whether they are bilateral or multi-lateral, informal or formal such as in the National Council of Provinces. Similar to the position in Germany these principles also play an important role in the financial intergovernmental relations in South Africa. The Budget Council and the Financial and Fiscal Commission are two important institutions that play a key role in the development and functioning of financial intergovernmental relations in South Africa.

The Budget Council was formally established in 1997 by the Intergovernmental Fiscal Relations Act.<sup>139</sup> This intergovernmental forum consists of the Minister of Finance, who chairs the Budget Council, and the Member of the Executive Council responsible for finance of each province. The Budget Council, which is a consultative body, meets regularly throughout the year to discuss intergovernmental financial matters, such as the annual division of revenue.

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<sup>139</sup> Sec 2 of Act 97 of 1997. These persons together with the top officials in the National Treasury and the nine provincial treasuries refer to themselves as “Team Finance”. See Ajam *The evolution of devolution: fiscal decentralisation in South Africa* in Abedian & Biggs *Economic globalization and fiscal policy* (1998) 54–69. See discussion of the role of the Budget Council in the financial equalisation process under **6.3**.



The Financial and Fiscal Commission was established under the 1993-Constitution as an independent advisory body on intergovernmental financial and fiscal matters.<sup>140</sup> The FFC plays an instrumental role in the process of the distribution of revenue between the national, provincial and local spheres of government as well as between the provinces. Under the 1996-Constitution continuity was ensured by the confirmation in section 220 (1) that “there is a Financial and Fiscal Commission for the Republic of South Africa”. The constitutional provisions are supplemented by the Financial and Fiscal Commission Act, 1997.<sup>141</sup> The members of the Commission are appointed by the President and include a chairperson and deputy chairperson and seven other persons.<sup>142</sup>

Co-operation among the different role players as well as mutual trust and respect is essential for the effective exercise of South Africa’s financial intergovernmental relations. Financial equalisation, as envisaged by section 214 of the Constitution, requires a great deal of co-operation between the various governments.

It is evident from the above discussion that co-operative federalism is a common characteristic of both the German and South African constitutional systems, although in South Africa the term “co-operative government” is used to describe the nature of intergovernmental relations. The application of this notion to the development of the financial constitution in both countries is of particular value to this dissertation.

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<sup>140</sup> Sec 199 of Act 200 of 1993; Mokgoro *Interprovincial Fiscal Equalization: The Role of the Financial and Fiscal Commission* in De Villiers (ed) *Birth of a Constitution* (1994) 281 285.

<sup>141</sup> Act 99 of 1997. See discussion of the role of the FFC under **6.2** and **6.3**.

<sup>142</sup> Initially the FFC included nine persons nominated by the provinces, two persons nominated by organized local government and nine other persons, but the Constitution was amended in 2001 (Act 61 of 2001) in order to have a smaller Commission.

### **3 Economic and financial considerations in the design of decentralised systems**

#### **3 1 Public finance**

#### **3 2 Expenditure allocation**

##### **3 2 1 Advantages of decentralised provision of public goods**

##### **3 2 2 Considerations in favour of national provision of public goods**

##### **3 2 3 Theoretical framework for expenditure allocation**

#### **3 3 Revenue allocation**

#### **3 4 Revenue sharing and intergovernmental grants**

##### **3 4 1 Revenue sharing**

##### **3 4 2 Intergovernmental grants**

#### **3 5 The South African situation**

#### **3 6 Conclusion**

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### **Chapter 3 Economic and financial considerations in the design of decentralised systems**

#### **3 1 Public finance**

According to traditional economic theory public finance includes both expenditure and revenue issues relating to the functioning of government.<sup>1</sup> Within this definition matters such as the allocation of resources, distribution of income and economic growth are also included. Although Musgrave's framework for public finance is based on a unitary system of government, the majority of economic theories on decentralised systems use this framework as the standard for the evaluation of decentralised systems. In this chapter an overview of economic considerations relating to expenditure as well as revenue allocation in the design of decentralised systems of government will be provided. Musgrave's widely used framework for public finance forms a useful point of departure for this discussion.

Musgrave describes the public economy of an imaginary state in terms of a fiscal department with three branches, namely the Allocation, Distribution and Stabilisation

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<sup>1</sup> Musgrave *The Theory of Public Finance* (1959) 3.

Branches.<sup>2</sup> In terms of this framework the Allocation Branch is responsible for determining the allocation of resources, adjustments required, the cost implications and deciding on the applicable revenue and expenditure policies. The Distribution Branch is responsible for adjustments in the distribution of income and wealth, while the Stabilisation Branch has the responsibility for ensuring economic stabilisation throughout the state. Although their functions are clearly defined, these branches are fundamentally interdependent. Ajam argues that when this framework is applied to a decentralised system of government a further function should be added, namely the constitutional function. This refers to the assignment of functions and responsibilities to the various levels of government.<sup>3</sup>

In applying the above approach to a federal or multi-level system of government, Musgrave described a system consisting of two levels of government, namely a federal and a state level, where decisions are taken at both levels and all individuals are citizens of both levels of government.<sup>4</sup> Oates defines "federalism" as a system of government that consists of two or more levels of government where decision-making regarding the provision of public services, takes place at both levels.<sup>5</sup> In terms of this approach, he argues that in economic terms most systems of government are federal in nature, but that they vary in terms of degree of centralisation or decentralisation. According to Oates, "federalism" accommodates the notion of different preferences for public services by consumers in various regions. This leads to a variety of public services, or at least to a varying degree in the level of public services provided in the various regions. In her discussion on the evolving system of intergovernmental fiscal relations in South Africa, Ajam describes "fiscal federalism" as the structure of public finances in a multi-tier system of government that includes issues relating to the

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<sup>2</sup> Musgrave *Public Finance* 5.

<sup>3</sup> Ajam *The Evolution of devolution: fiscal decentralisation in South Africa* in Abedian & Biggs *Economic globalization and fiscal policy* (1998) 54 79.

<sup>4</sup> Musgrave *Public Finance* 179. See also Musgrave *Public Finance in a Democratic Society* (Vol II) (1986) 3 - 8 for a discussion on multi-level finance.

<sup>5</sup> Oates *Federalism and Government Finance* in Quigley & Smolensky (eds) *Modern Public Finance* (1994) 127; Oates *Fiscal Federalism* (1993) 14 - 17; Oates *The Political Economy of Fiscal Federalism* (1977) 4.

allocation of taxing, spending and regulatory functions to the various levels of government and the transfer of funds between them.<sup>6</sup>

In the field of political science, the concept of "federalism" has evolved over time from a fairly narrow definition according to Wheare to a more inclusive notion that covers a variety of multi-level systems of government. Wheare described a federal system of government as one that consists of two independent levels of government with powers being divided between the two.<sup>7</sup> Currently a commonly accepted approach, as developed by constitutional experts that include Elazar, Watts and Simeon, is that "federalism" includes a wide range of various multi-level systems of government.<sup>8</sup> Simeon suggests that each federation seems to be *sui generis* in view of political and other factors that when combined with the basic federal design, impact on the nature and functioning of the federal system.<sup>9</sup>

In terms of Musgrave's framework, public services are provided by both levels of government. Some services are provided throughout the country by the federal government while other services are provided by each state or region for its respective area of jurisdiction. Services such as defence, that benefit the whole country, are provided at national level, while public services such as refuse removal, that have a local impact, are provided at local level.<sup>10</sup> It follows that services provided at national level should be paid for with taxes levied on a nation-wide basis, while locally provided services should be financed by local taxes. This is in line with the economic principle of benefit finance that stipulates that services provided by any jurisdiction should be paid for by the members of that jurisdiction.<sup>11</sup>

This economic framework provides that taxes are levied at the federal as well as the regional<sup>12</sup> level of government, and assumes that regional taxes may differ from one region to another, in order to fund the public services provided within that

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<sup>6</sup> Ajam *Fiscal decentralisation in South Africa* 54.

<sup>7</sup> Wheare *Federal Government* (1956) 11.

<sup>8</sup> For a discussion on the terms "federalism" and "federal system" see 1.1.3.

<sup>9</sup> Simeon "Considerations on the design of federations: the South African constitution in comparative context" 1998 (13) *SAPR/PL* 42 50.

<sup>10</sup> Musgrave uses a two level model of government, namely a federal and a state or regional level. His reference here to the local level is thus a reference to the state or regional level of government.

<sup>11</sup> Musgrave *Public Finance in a Democratic Society* (Vol III) (2000) 411.

<sup>12</sup> In this Chapter the term "region" is used as reference to a province/state/Land.

jurisdiction. Musgrave further argued that the people living in various states or regions could express different preferences for public services. This may lead to differences in the levels of public services provided and taxation levied at state level. This issue falls within the sphere of the Allocation Branch. Musgrave concluded his discussion on fiscal federalism by stating, "The heart of fiscal federalism thus lies in the proposition that the policies of the Allocation Branch should be permitted to differ between states, depending on the preferences of their citizens. The objectives of the Distribution and Stabilisation Branches, however, require primary responsibility at central level."<sup>13</sup> This conclusion by Musgrave is supported in literature by economists such as King and Oates.<sup>14</sup>

It would be fair to state that macro-economic stability and policies for the redistribution of wealth and income are primarily functions of a central government, while the accommodation of a variety of consumer preferences, for the provision of public goods, is best at the sub-national government level. In a more recent publication, Musgrave described the allocation of functions in modern multi-level systems of government and concluded that a decentralised provision of public goods paid for by those who benefit from them, together with a centralised distribution policy seems to be the most appropriate design for these systems.<sup>15</sup> This approach to fiscal federalism provides some guidance for the design of decentralised systems of government when considering the allocation of expenditure and the revenue functions of the various levels of government.

Economic literature generally suggests that in decentralised systems the allocation of expenditure responsibilities takes place before the allocation of revenue sources due to the uncertainty of the quantum of revenue required at regional or local level. It might, however, be useful to consider the allocation of both expenditure responsibilities and revenue sources simultaneously in order to improve the matching of expenditure and revenue sources at regional government level.<sup>16</sup> Be that as it may,

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<sup>13</sup> Musgrave *Public Finance* 181.

<sup>14</sup> Oates *Federalism and Government Finance* 129; Oates *Political Economy* 5 - 6; King *Fiscal Tiers: The Economics of Multi-Level Government* (1984) 36.

<sup>15</sup> Musgrave *Democratic Society* (Vol III) 333.

<sup>16</sup> Shah *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies* (1994) 9.

it is essential that the issue of revenue assignment not be discussed in isolation and that the allocation of expenditure responsibilities be closely involved in the discussions.

In the discussion below, the general trend found in economic literature will be followed, namely a discussion about expenditure allocation followed by revenue allocation. The issue of revenue sharing and intergovernmental grants will also be discussed.

### **3 2 Expenditure allocation**

The provision of public goods, for example education or health services, is the primary responsibility of the government while the consumers or citizens pay for it by way of taxes. According to basic economic theory concerning multi-level systems, the residents of the area that benefit from the service should pay for it.<sup>17</sup> In line with this basic economic theory, Oates, in his discussion on decentralisation in federal systems, stated that a decentralised solution to the question of resource allocation and the provision of public services is the preferred option for a federal system.<sup>18</sup> This implies that sub-national governments are better placed to take care of the variety of local demands when providing public services within their respective jurisdictions. The validity of this approach depends on two conditions, namely the absence of any spill over effects and existing economies of scale. Spill over effects would occur when one sub-national government delivers services that people from another area also use without paying for the services. An example of this is where an advanced hospital attracts patients from outside the area in which it operates. Economies of scale can be created if the central government provides a service, which can be provided by the various sub-national governments, at a more cost-effective basis.

Oates' decentralisation theory further provides for a decentralised system of government consisting of multiple levels of government, where each government is responsible for the provision of public services in the most efficient manner for

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<sup>17</sup> Musgrave *Democratic Society* (Vol III) 331.

<sup>18</sup> Oates *Political Economy* 5 - 6, Oates *Fiscal Federalism* 35 - 38.

consumers within their respective jurisdictions. Local provision of services is efficient if the benefits are local, for example the provision of household water. If benefits are gained countrywide, the service required may be provided more efficiently at the national level.<sup>19</sup> In practical terms, it implies that the functions of defence and foreign affairs should be allocated to the national level of government, while functions, where different needs of consumers must be accommodated and where services can be performed more efficiently on a decentralised basis, such as education, health and police, should be allocated to the regional level of government.

This economic framework for the allocation of expenditure functions thus suggests that functions should be allocated to the lowest possible level of government if such level of government can perform such functions efficiently.<sup>20</sup> Realities such as differences in economic strength, fiscal capacity or social welfare issues of the various sub-national governments however cast some shadows over this theoretical framework. These realities clearly need to be considered when decisions are made regarding the constitutional allocation of expenditure responsibilities and revenue sources.<sup>21</sup>

### **3 2 1 Advantages of decentralised provision of public goods**

Regional and local governments, due to their close proximity to the citizens or consumers within their areas of jurisdiction, generally have more information about the needs and preferences of their citizens than the national government has. They can thus package the provision of services more accurately in accordance with their consumer's preferences. This is an attractive economic perspective, as it would lead to a more efficient provision of public services.<sup>22</sup> Regional and local governments, being closer to the people, are thus more likely to produce a variety of public goods with a varying degree of quality and quantity in order to accommodate consumer preferences. If the same service, for example primary education, is provided at the

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<sup>19</sup> Musgrave *Democratic Society* (Vol III) 331.

<sup>20</sup> Shah *Intergovernmental Fiscal Relations* 9, Musgrave *Democratic Society* (Vol III) 331. See 1 2 for a brief discussion of the subsidiarity principle, which has some bearing on the arguments raised in the literature about the economic theory of fiscal federalism.

<sup>21</sup> Musgrave *Democratic Society* (Vol III) 332.

<sup>22</sup> Ajam *Fiscal decentralisation in South Africa* 93.

national government level and not at the regional or local level, the variety of consumer preferences cannot be accommodated since uniform centralised policy requires that uniformity in the provision of the service must exist throughout the country. This may result in a loss of efficiency. Economic efficiency is enhanced when a government is more responsive to the preferences of its citizens in the provision of public services.<sup>23</sup>

When public services are delivered at differing levels of quality and quantity by various regional or local governments, consumers are left to decide which package of public services best suit their needs. The theoretical model for provision of public services by sub-national governments developed by Tiebout (1956) suggests that the citizens or consumers can vote with their feet by moving to the community or region that best reflects their preferences. This model presupposes complete mobility of citizens between the various jurisdictions. In practice there are, however, a number of factors that impact on this model. In a country like South Africa, where there are huge socio-economic disparities and other differences between the various provinces, factors such as poverty, fiscal capacity and administrative ability of provinces and municipalities to deliver public services have a significant influence on the mobility of the citizens or consumers. This also impacts on the economic efficiency of the provision of public services.

Another advantage is enhanced competition and innovation. Decentralised provision of public services and decentralised decision-making leads to healthy competition between various regional or local governments. Competitive pressures in turn lead to more innovation in search for new and improved ways of providing public services. Centralisation of functions generally provides little scope for experimentation and innovation for the provision of public services and can easily lead to rigid practices being implemented.<sup>24</sup> In their endeavours to search for improved efficiency for the provision of public services, regional and local governments can experiment with new techniques of production that may result in lower costs than would be possible at the

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<sup>23</sup> Wellisch *The Theory of Public Finance in a Federal State* (2000) 14; Oates *Fiscal Federalism* 13; Oates *Political Economy* 7; King *Fiscal Tiers* 20.

<sup>24</sup> Ajam *Fiscal decentralisation in South Africa* 94.



level of national government.<sup>25</sup> Successful innovation experiments can also be exported to other regions, for example if, in the case of South Africa, the Western Cape has developed a successful client care model for the payment of social support grants, that model can be exported to the other eight provinces in the country.

Successful competition and innovation may, however, also have negative effects that need to be addressed. A province may for example have excellent primary schools and it will draw learners from areas outside that province where the quality of primary school education is not so good. It might cause a need for more classrooms or new schools. This places additional demands on the budget of that province. One possible way of addressing this demand would be by way of grants from the national government.

Decentralised decision-making and the provision of public services eliminates the need for a central administration as well the need for regional or local branch offices. This results in a more cost-effective provision of public services at the regional or local level, while the national government can focus its attention on the performance of purely national public functions. In geographically larger or more populous countries, this benefit is more important in view of the increasing complexity to provide public services to larger communities. In other words, decentralised provision of public services is more cost-effective in a country covering a large geographical area or having a large population.<sup>26</sup>

A further advantage of the sub-national provision of public goods is the potential it holds for the promotion of good governance values such as accountability, public participation and the accommodation of diversity. These values should be pursued with equal vigour throughout the country, but are highlighted at provincial and local government levels where government is closer to the people. Decentralisation of public services creates more opportunities for the citizens of a particular region or municipality to engage their elected representatives in policy issues and the actual

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<sup>25</sup> Wehner *Fiscal Federalism in South Africa* (1999) 19; Oates *Fiscal Federalism* 13.

<sup>26</sup> Wehner *Fiscal Federalism in South Africa* 19.

provision of public services.<sup>27</sup> Regional and local governments can create various mechanisms to enhance effective public participation for the benefit of the citizens of their particular jurisdictions. Bringing government closer to the people will enhance their ability to discuss and debate policy and delivery issues with the respective regional or local governments. Accountability of regional and local governments can be strengthened through direct and regular interaction with the citizens in their area of jurisdiction.

### **3 2 2 Considerations in favour of national provision of public goods**

There are limits to the extent to which decentralisation of expenditure responsibilities is desirable, even from a purely theoretical economic perspective. Some public services can, due to economies of scale, be provided more efficiently at a national level, for example national defence, where the benefits are for the whole country and not only for a particular regional or local government.<sup>28</sup> This argument is also valid where regional governments provide certain services more cost effectively than the local governments within their area of jurisdiction, for example the provision of primary education.

Spill over effects can exist in case of benefits and cost. Both these can result in an inefficient provision of public services at regional or local level. In view of the openness of regional and local economies, benefit spillovers develop when non-residents also benefit from the provision of services within a particular region, for example unique or better hospital services in one region attract people from other regions who can also benefit from it. Cost spillovers exist when the cost of a service is exported from one region to another, for example when a regional or local government cuts its spending on health services, its residents might decide to use similar services in neighbouring areas.<sup>29</sup> In order to limit spill over effects or where the benefits of a specific public service are national in character, public services can be provided more efficiently at national level. Likewise, if the benefits of a specific

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<sup>27</sup> Ajam *Fiscal decentralisation in South Africa* 94.

<sup>28</sup> Ajam *Fiscal decentralisation in South Africa* 94; Oates *Fiscal Federalism* 37.

<sup>29</sup> Wehner *Fiscal Federalism in SA* 20; Oates *Fiscal Federalism* 32.

public service are regional rather than local in character, such service can be provided more efficiently at the regional level.

There is general acceptance amongst economists that the macro-economic stabilisation and redistribution functions should be allocated to the national level of government in view of the limited scope for regional and local redistribution and stabilisation policies.<sup>30</sup> Although regional governments have some role to play in redistribution policies, for example providing basic education to all residents, the scope for redistribution across regions is limited. If a regional or local government decides to redistribute income to other areas, it would cause a decrease in consumption for their own residents. This is an inefficient resource allocation. Redistribution of income and wealth among regions or local governments can thus be achieved more efficiently at national level. Macro-economic stabilisation policies, such as monetary policy and setting inflation and debt targets are national in character and should be performed at national level and<sup>31</sup> according to economic theory not be allocated to regional or local governments.

### **3 2 3 Theoretical framework for expenditure allocation**

In accordance with the above discussion, the following provides a theoretical economic framework for the allocation of expenditure responsibilities in a decentralised system of government.

The basic approach followed is that expressed by Oates, namely that each particular jurisdiction (government) is responsible for the provision of public services for the consumers within their own jurisdiction in the most efficient way possible.<sup>32</sup> Musgrave stated, with reference to the provision of public services in decentralised systems of government, that the benefits of public services are enjoyed jointly by consumers in various jurisdictions, but that the spatial range of benefits gained

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<sup>30</sup> Wellisch *Public Finance* 20; Oates *Federalism and Government Finance* 128 - 129; Oates *Fiscal Federalism* 33; King *Fiscal Tiers* 44; Musgrave *Public Finance* 181.

<sup>31</sup> Wehner *Fiscal Federalism in South Africa* 18; Ajam *Fiscal decentralisation in South Africa* 85.

<sup>32</sup> Oates *Fiscal Federalism* 35 - 38.

differs.<sup>33</sup> The most economically efficient allocation is achieved when the cost of provision of particular public goods is determined and paid for by the consumers or citizens of the area that benefit from those goods.

This theoretical framework for expenditure allocation depends on a division of public goods into distinct categories, namely national public goods on the one hand, and regional or local public goods on the other. In reality, most public goods provided by governments do not fit neatly into one of these categories and this warrants some form of shared responsibility.<sup>34</sup> An example of "mixed public goods" is education, where the actual provision of education can for example be the responsibility of the regional governments, while policy and the setting of national standards are the responsibility of the national government. In constitutional law, these public goods are referred to as concurrent functions. The provision of "mixed public goods" is quite important in the case of South Africa, where most of the provincial government functions fall within the category of concurrent functional areas.<sup>35</sup>

Public services where the cost and benefits are national in scope, should be provided for by the national government. Examples of these are defence, currency and banking and immigration. Regional and local governments should provide those public services where cost and benefits are limited to their respective areas of jurisdiction, for example primary and secondary education (regional responsibility) and street lighting and refuse removal (local responsibility). In view of the fact that most public services are so-called mixed goods, public services could be allocated to more than one level of government, for example health services and agriculture.<sup>36</sup> The costs and benefits of these services are shared in some way by the respective jurisdictions. In addition to this basic economic framework, it should be noted that there are various factors that impact on the particular assignment of expenditure responsibilities such as

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<sup>33</sup> Musgrave *Democratic Society* (Vol III) 331, 411.

<sup>34</sup> Wehner *Federalism in South Africa* 21; Shah *Intergovernmental Fiscal Relations* 12.

<sup>35</sup> Schedule 4 of the 1996-Constitution contains 33 functional areas of concurrent national and provincial legislative competence.

<sup>36</sup> Shah *Intergovernmental Fiscal Relations* 12.

the administrative capacity of regional governments, equity considerations and political choices.

### **3 3 Revenue allocation**

In the basic economic model of Musgrave consumers pay for public services in accordance with the benefits they receive by paying taxes. This benefit pricing structure suggests a very simplistic model of financing public services. In a federal system the financing of public services is compounded by the existence of more than one level of government. In Musgrave's model the Allocation Branch, both at national and at regional level, is responsible for financing the cost of the public services it provides. It does this by levying taxes. It is evident that, according to Musgrave's approach, each level of government must have sufficient revenue sources in order to finance its expenditure functions. This basic model of benefit pricing does not take into account issues such as the existence of benefit and cost spillovers from one jurisdiction to another, or the fact that taxes are not always based on the benefit rule, but often on residents' ability to pay.<sup>37</sup> In view of the limited application of benefit pricing to finance public services, this basic economic model does not provide the final answer to the question of revenue allocation to the various levels of government in a federal system. In addition to the allocation of expenditure functions, it must be determined how taxes or revenue should be assigned to the various levels of government.

Based on the Musgrave model the following guidelines are commonly used for the allocation of taxes:<sup>38</sup>

Highly progressive taxes, such as personal income tax with a sliding scale of tax rates, with redistributive objectives should be the responsibility of the national government. According to Tiebout's reasoning consumers will shop among different regions to find the region where the prices (taxes) of public services fit their needs the best. A

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<sup>37</sup> Musgrave *Democratic Society* (Vol III) 412.

<sup>38</sup> Oates *Federalism and Government Finance* 131. See also Wehner *Federalism in South Africa* 24 - 26.

regional or local government that wants to increase its revenue in order to redistribute income from rich residents (high income tax) to poor residents (low or no income tax) might find itself in an unwanted situation where it loses rich residents to other regions and it draws poor residents. In order to avoid such a scenario progressive personal income tax should be assigned to the national government.<sup>39</sup>

Taxes on highly mobile tax bases such as personal and corporate income tax should be centralised. Economic problems occur when these taxes are levied at local government level. Individuals and businesses are mobile and will choose the area with the tax regime that is more beneficial to them. Due to competition, different income tax rates will lead to a relocation of individuals and businesses from an area with a high tax rate to an area with a lower rate of income tax. This may cause distortion in the economy and erosion of the tax base.<sup>40</sup> There is, however, a possibility that the responsibility for income tax can be shared in some way between the national and regional governments. In some countries like Germany both personal and corporate income tax are shared between the *Bund* and the *Länder* by way of a constitutional guarantee to that effect.<sup>41</sup> It should, however, be noted that it is the revenue from these taxes that is shared, while the tax rate is determined by the *Bund*. Another way of sharing taxes is tax co-ordination of the same tax base between different levels of government.<sup>42</sup> In practice, this means that the lower level government is allowed to add a levy or surcharge onto an existing tax base levied by the national or regional government, such as onto income or sales tax. A proposal to this effect was made by the Financial and Fiscal Commission (FFC) in the development of the financial intergovernmental relations system in South Africa.<sup>43</sup> However, to date there has not yet been any provincial levy or surcharge on a national tax base.

Taxes with tax bases distributed unevenly between various regions should be allocated to the national government in order to avoid distortions in revenue allocation

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<sup>39</sup> Oates *Federalism and Government Finance* 131.

<sup>40</sup> Oates *Federalism and Government Finance* 131.

<sup>41</sup> Art 106 (3) of the Basic Law.

<sup>42</sup> Oates *Fiscal Federalism* 148.

<sup>43</sup> FFC *Framework document for Intergovernmental Fiscal Relations in South Africa* (1995) 20. This matter will be discussed in more detail under **4 3 1**.

among the various jurisdictions.<sup>44</sup> Taxes on natural resources such as oil and minerals are examples of these taxes.

Economies of scale in tax administration at the national level of government result in a cost saving in nationally administered taxes such as income tax and value-added tax.<sup>45</sup> In addition to the above-mentioned benefits of allocating the authority to levy these taxes to the national government, there is an additional advantage in the centralisation of certain taxes, namely saving in administrative costs.

According to the arguments raised above, it seems that the most important taxes or the taxes with potentially the highest yield should be the responsibility of the national government. Not all taxes should however be centralised. The following are some economic arguments for decentralisation of some taxes and other sources of revenue.

Taxes on immobile tax bases such as land or fixed property tax should be decentralised to regional or local governments in view of the fixed nature of the tax base.<sup>46</sup> Any competition among regional or local governments regarding such taxes will have a limited effect on the movement of residents from one area to another, thus making it appropriate to be assigned to regional or local governments.

Benefit taxes such as user charges or licence fees can be levied at all levels of government, although it is more attractive for regional and local governments.<sup>47</sup> User charges or user fees are fees that are levied by a government for the provision of a public service where the benefits accrue to the consumers or citizens within that particular jurisdiction, for example fees for the use of a public nature reserve. The users of public roads within a particular region can for example be charged with a motor vehicle license fee in order to cover the costs of that public service.

In accordance with Musgrave's benefit pricing structure, consumers must pay for public services according to the benefits they receive. The cost to the government for

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<sup>44</sup> Musgrave *Democratic Society* (Vol III) 298; Oates *Federalism and Government Finance* 131.

<sup>45</sup> Oates *Political Economy* 15.

<sup>46</sup> Oates *Federalism and Government Finance* 131.

<sup>47</sup> Musgrave *Democratic Society* (Vol III) 299.

providing public services can be in the form of taxes, as discussed above, or in the form of user fees or licenses, where there is a direct link between the benefit to the consumer and the cost of the service. Due to the close link between cost and benefits to particular consumers, user fees have limited potential for distorting incentives to move from one area to another. In Tiebout's mobility model consumers will choose their area of residence according to their preferred price package; that is, their preferred combination of taxes and public services.<sup>48</sup> User fees will in this context enhance the efficiency of resource allocation due to more efficient decisions by mobile consumers.<sup>49</sup>

Shah used an alternative framework for tax assignment in his discussion on fiscal intergovernmental relations.<sup>50</sup> This framework consists of only two criteria, namely efficiency in tax administration and fiscal need; that is, the amount of revenue required to satisfy the allocated expenditure responsibilities. More efficient tax administration is provided by allocating taxing authorities to the level of government that is likely to have the best available information on a tax base. In accordance with this criterion, property taxes should be allocated to the local government level. The application of fiscal need implies that revenue sources should be matched as closely as possible with expenditure responsibilities. The following are examples of tax assignment in accordance with Shah's framework, namely:

Customs duty, value added tax	National government;
Motor vehicle licenses	Regional government;
Property and land tax	Regional and local government. <sup>51</sup>

It seems from the above discussion, that the two different approaches to allocation of revenue responsibilities produce, in general, the same results.

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<sup>48</sup> Musgrave *Democratic Society* (Vol III) 297; Oates *Fiscal Federalism* 149.

<sup>49</sup> Oates *Federalism and Government Finance* 131; Oates *Political Economy* 7.

<sup>50</sup> Shah *Intergovernmental Fiscal Relations* 18 - 21.

<sup>51</sup> Shah *Intergovernmental Fiscal Relations* 19.



### 3 4 Revenue sharing and intergovernmental grants

A fiscal gap occurs when there is a mismatch between the allocation of expenditure responsibilities and revenue sources to a particular tier or sphere of government.<sup>52</sup> In decentralised systems of government, a vertical fiscal imbalance can occur when most of the high yielding revenue sources are allocated to the national government, while proportionally more expenditure responsibilities are allocated to the regional or local governments. Such a situation can be the result of various factors including economic considerations, historical development and political choices. According to Boadway, efficient fiscal decentralisation focuses on the decentralisation of expenditure responsibilities rather than revenue-raising responsibilities, a situation that is quite common in decentralised systems of government.<sup>53</sup> In this scenario a fiscal gap or fiscal imbalance is created and this leads to the need for some form of revenue sharing among the various governments, or the introduction of intergovernmental grants or both. Two types of fiscal gaps can occur, namely a horizontal fiscal gap, if there is an uneven distribution of financial resources in relation to expenditure responsibilities at the same level of government, and a vertical fiscal gap if more expenditure responsibilities than financial resources are decentralised.<sup>54</sup>

In addition to the basic economic requirements that each level of government should have sufficient revenue in order to fund its expenditure functions, it should be noted that there are also social and political considerations that influence fiscal decentralisation, for example social development programs or political commitment to decentralisation. One of the important features of a decentralised system of government is the redistribution of income by national-regional transfers. These can be based on economic, social or political considerations. Boadway argues that

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<sup>52</sup> Ajam *Fiscal decentralisation in South Africa* 57.

<sup>53</sup> Boadway *Burden Sharing or Dividing the Spoils* (1999) 4; Boadway & Keen *Efficiency and the Optimal Direction of Federal-State Transfers* in Wildasin *Fiscal Aspects of Evolving Federations* (1997) 41.

<sup>54</sup> Wehner *Fiscal Federalism in South Africa* 28.

redistributive intergovernmental transfers are an indispensable complement to the decentralisation of expenditure responsibilities.<sup>55</sup> This is evidenced in both the German and South African constitutional systems.

Intergovernmental revenue sharing and grants are the mechanisms used to narrow or close fiscal gaps. It is, however, not merely a mathematical exercise, as various other considerations impact on the design of intergovernmental revenue sharing and transfer arrangements. Some of these are the need for redistribution of revenue (for example in post-1994 South Africa) and the existence of imbalances in the fiscal capacity of the various regions, for example the disparities between the new and old *Länder* after unification of Germany in 1990. In search of an appropriate intergovernmental revenue sharing and transfer scheme for a particular decentralised system of government, all the relevant factors should be considered. In any decentralised system of government, financial intergovernmental arrangements, including the allocation of expenditure and revenue responsibilities, but change over time and will reflect the balance of centrifugal (decentralising) and centripetal (centralising) forces at any particular point in time.<sup>56</sup>

A number of different criteria, that are often in conflict with each other, should be considered in the design of financial intergovernmental arrangements,<sup>57</sup> namely: -

- ❖ the degree of fiscal autonomy of regional and local governments;
- ❖ allocation of sufficient revenue to regional and local governments;
- ❖ ensuring an equitable allocation of funds;
- ❖ predictability of regional and local governments' financial allocations;
- ❖ ensuring efficiency of resource allocation to regional and local governments without compromising their decision-making authority to decide on their internal resource allocation;
- ❖ simplicity of design based on objective factors;
- ❖ inclusion of incentives to improve sound financial management and to discourage inefficient financial management; and

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<sup>55</sup> Boadway *Burden Sharing* 1; Oates *Federalism and Government Finance* 133.

<sup>56</sup> Ajam *Fiscal decentralisation in South Africa* 57; Oates *Federalism and Government Finance* 149.

<sup>57</sup> Shah *Intergovernmental Fiscal Relations* 30.

- ❖ guarantees, in the case of borrowing, for ensuring the achievement of the grantor's objectives.

A carefully obtained balance when considering these criteria in the design of financial intergovernmental arrangements will enhance the successful implementation of such a scheme.

Revenue sharing<sup>58</sup> and intergovernmental grants differ from one system to another and depend largely on the nature and content of the expenditure responsibilities and revenue sources allocated to the various regions. Various considerations in the design of revenue sharing mechanisms and intergovernmental grants in decentralised systems are discussed below.

### **3 4 1 Revenue sharing**

In a federal system the benefits of centralised taxes combined with that of decentralised expenditure functions could be maximised through revenue sharing between the different levels of government.<sup>59</sup> Regional governments can effectively use the national government as tax collecting agent while retaining their expenditure responsibilities. Such an arrangement has the advantage of a cost saving on tax administration in view of the economies of scale at the national government level. Due to the additional income received by way of revenue sharing, sufficient scope to accommodate a variety of consumer preferences at regional government level is thus provided.

Revenue sharing relationships can substantially reduce vertical fiscal imbalances and realise more efficient resource allocation among the various levels of government, but this depends on the exact relationships formed. Revenue sharing does not relieve

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<sup>58</sup> Although revenue sharing and sharing of taxes might *prima facie* seem to be the same, it can be easily distinguished. Sharing a particular tax, e.g. personal income tax, is a much narrower concept than revenue sharing, which can include revenue from a number of taxes as well as revenue obtained through loans. See Shah *Intergovernmental Fiscal Relations* 23.

<sup>59</sup> Oates *Political Economy* 14.

regional or local governments from their responsibility to raise a substantial portion of their own revenue. An increase in own revenue creates more scope for discretion in setting expenditure priorities and accommodating consumer preferences at regional and local government levels. This is in line with the basic economic theory, discussed earlier in this Chapter, namely that each government should finance its own expenditure functions. It also leads to fiscally responsible regional or local government.

Revenue sharing mechanisms are quite common in decentralised systems of government, but they are shaped in various forms. They can be based on a formula incorporating various factors such as population, number of school-going children and regional fiscal capacity.<sup>60</sup> Such arrangements exist in South Africa where provincial and local governments are entitled to an equitable share of nationally raised revenue.<sup>61</sup> Alternatively, revenue sharing can be a simple arrangement whereby regional governments are allocated a fixed percentage of nationally raised revenue. From a legal perspective, such revenue sharing arrangements would require national legislation or constitutional provisions or both, to provide legal certainty to the relevant governments as well as to the citizens of the country. Both Germany and South Africa have included particular provisions regarding revenue sharing in their respective constitutions, thus laying a sound basis for the actual revenue sharing arrangements.<sup>62</sup> This will be discussed in more depth in **Chapters 5 and 6** respectively.

### **3 4 2 Intergovernmental grants**

#### **3 4 2 1 Objectives**

Specific considerations apply to intergovernmental grants. They are not merely given to ensure that there is sufficient revenue for regional and local governments to fund their expenditure functions.

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<sup>60</sup> Shah *Intergovernmental Fiscal Relations* 23.

<sup>61</sup> Ajam *Fiscal decentralisation in South Africa* 69; Sec 214 of the 1996-Constitution.

<sup>62</sup> Art 106, 106a and 107 of the Basic Law; sec 214, 227, 228 and 229 of the 1996-Constitution.

The process of developing fiscal decentralisation results in some regions having bigger fiscal capacity to provide public services and raise revenue than others. This net fiscal benefit varies from one region to another for a number of reasons.<sup>63</sup> One reason is that certain regions may have more natural resources or economic activities that increase their revenue raising capacity. Another reason is that some regions may have less expenditure needs, for example fewer school-going children or fewer old age homes. These differences imply different levels of fiscal benefits to consumers in the various regions and result in horizontal inequities.<sup>64</sup> Vertical inequity, which is also a common feature in federal systems, will occur when more expenditure responsibilities than revenue raising responsibilities are decentralised.

In a situation of horizontal inequity people in equal positions residing in different regions are not treated equally by the respective regional governments. In order to address this situation, intergovernmental grants can be transferred from regions with higher fiscal capacity to regions with lower fiscal capacity. This should enable all regions to deliver comparable public services at comparable tax rates to their consumers. Ideally, such equalisation grants would still allow regional governments the freedom to determine their own expenditure priorities according to their specific needs.

Vertical inequity can be addressed either by way of a revenue sharing arrangement, as discussed above, or by way of intergovernmental grants or both. These arrangements should put regions in a better financial position to fund their expenditure responsibilities.

Intergovernmental grants can be used for various reasons. There are two fundamental considerations applicable to decisions on intergovernmental grants, namely equity and efficiency. Fiscal equalisation grants aimed at eliminating or reducing differential net fiscal benefits between regions, can enhance the equity as well as the efficiency of a federal system.<sup>65</sup> From a purely economic perspective, redistribution is not an end in itself, but is introduced to ensure that individuals in equal positions are treated equally

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<sup>63</sup> Shah *Intergovernmental Fiscal Relations* 29.

<sup>64</sup> Boadway *Burden Sharing* 5.

<sup>65</sup> Shah *Intergovernmental Fiscal Relations* 29.

throughout the federation.<sup>66</sup> Redistribution is, however, not a neutral economic concept as it has a distinct political character. Redistribution of land or income in a country such as South Africa with huge disparities, can have distinct political aims, for example, economic empowerment and the economic objective of equal treatment of all individuals.

Equity is thus an important consideration underlying both vertical and horizontal equalisation. It should be noted that the objective of equity does not only relate to pure economic reasoning, but it requires a value judgement, which introduces a subjective political element. Implicit in decentralised expenditure responsibilities is a degree of discretion that allows regions to take decisions. Intergovernmental transfers used for equalisation put regions in a position to provide comparable public services at comparable cost (tax rates), but do in principle not require uniformity.<sup>67</sup>

Efficient provision of public services by a regional or local government will result in spillovers, for example if a region provides excellent health services they will not only be used by its residents but also by residents from neighbouring regions that do not provide a high standard of health services. Regional governments will need extra funding in order to effectively take care of such spillovers. Alternatively, they may choose to provide such public services only to its residents and improve its own resource allocation. This solution, however, does not take practicalities such as the mobility of people between regions into account, and is therefore not a useful alternative. Intergovernmental transfers aimed specifically at reducing inefficiencies caused by spillovers are necessary to provide regions with the extra funding they require.<sup>68</sup>

A further aim of intergovernmental grants is the requirement of minimum standards of delivery of particular public services by regional or local governments. Apart from social or political considerations for the setting of common minimum standards for public services, considerations of economic efficiency also justify such minimum

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<sup>66</sup> Boadway *Burden Sharing* 6. The principle that people in equal positions should be treated equally is a widely accepted principle of equity in taxation - see Musgrave *Public Finance* 160.

<sup>67</sup> Boadway *Burden Sharing* 6; Ajam *Fiscal decentralisation in South Africa* 92; Oates *Fiscal Federalism* 85; King *Fiscal Tiers* 146.

<sup>68</sup> Wehner *Fiscal Federalism in SA* 29; Oates *Fiscal Federalism* 85.

standards throughout a federation.<sup>69</sup> Labour mobility is for example improved by the establishment of minimum standards for the provision of social services.

### **3 4 2 2          Design of intergovernmental grants**

Various types of intergovernmental grants can be used and the design of these is of critical importance to the financial health of the regional and local governments. The various objectives discussed above should be carefully considered when deciding on the types and scope of intergovernmental grants.

A useful classification of intergovernmental grants that is commonly used is to have a basic distinction between conditional or specific grants and unconditional or general grants.<sup>70</sup> An alternative classification is that used by Shah when he distinguished between non-matching (conditional or unconditional) grants and selective matching (conditional) grants.<sup>71</sup> Conditional or specific grants are grants where the grantor defines the purposes for which the recipient government must use the grants, or specific conditions are attached to the allocation of the funds.<sup>72</sup> Due to the setting of conditions the freedom of recipient governments to utilise conditional grants is limited. General or unconditional grants, on the other hand, are funds allocated to the recipient government to be used at its discretion. These grants are sometimes also referred to as block grants. Recipient governments prefer unconditional grants that can increase flexibility in their decision-making.

Conditional grants can be divided in two subdivisions, namely matching grants and non-matching grants.<sup>73</sup> Matching grants require that the recipient government uses the grant for specific purposes and it matches the receipt of funds to a specified degree from its own sources. An example of a matching conditional grant would be when the national government allocates a grant to a regional government to be used for the improvement of technical schools on a 50% matching basis. By using matching grants the national government is able to influence spending priorities at

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<sup>69</sup> Wehner *Fiscal Federalism in SA* 29; Shah *Intergovernmental Fiscal Relations* 29.

<sup>70</sup> Oates *Fiscal Federalism* 65; King *Fiscal Tiers* 87.

<sup>71</sup> Shah *Intergovernmental Fiscal Relations* 24.

<sup>72</sup> Oates *Fiscal Federalism* 65; King *Fiscal Tiers* 87.

<sup>73</sup> Shah *Intergovernmental Fiscal Relations* 26; Oates *Fiscal Federalism* 65; King *Fiscal Tiers* 88.

regional or local government level. Matching grants can be further subdivided into capped and open-ended matching grants.<sup>74</sup> In the case of capped grants a limit is placed on the amount to be transferred by stipulating for example that the grant is on a 50% matching basis but limited to a maximum of R1 million spent by the recipient government. Open-ended matching grants do not have any limit for the total amount of the grant and are merely determined by stipulating a percentage of the recipient's expenditure, for example 50%. This type of grant can be used to correct inefficiencies at regional or local government level caused by benefit spillovers, where the cost of the benefits of a particular service to non-residents is used to determine the extent of the grant.<sup>75</sup>

Conditional grants can be used to ensure that minimum or national standards for the provision of specific public services are maintained throughout the country. The recipient regional or local government is obliged to achieve the minimum standards in order to receive the conditional grant. This creates a limitation at regional or local government level when deciding on expenditure priorities. The national government on the other hand establishes a degree of budgetary control over spending priorities at regional or local level by providing conditional grants. In contrast, unconditional grants are free of any restraints on the discretion of recipient governments and they determine their own expenditure priorities using the funds made available. The use of unconditional grants broadly is in line with the essence of federalism, namely the existence of different levels of political decision-making mechanisms.<sup>76</sup> There are sound reasons for the use of conditional grants in particular cases, for example, to contribute to the equity and national efficiency objectives of the government.

### **3 5 The South African situation**

A discussion of economic and financial considerations in the design of decentralised systems of government should not be limited to an abstract theoretical discussion. It should be placed within the proper practical context.

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<sup>74</sup> Shah *Intergovernmental Fiscal Relations* 26; King *Fiscal Tiers* 88.

<sup>75</sup> Shah *Intergovernmental Fiscal Relations* 26.

<sup>76</sup> Boadway *Burden Sharing* 8.



When applying the economic framework discussed in this Chapter to South Africa, particular care is required. One should be sensitive to local conditions such as the very high unemployment rate<sup>77</sup> (and its potential to cause political instability) and the uneven distribution of the tax base. Government income is mainly derived from personal income tax, company tax and value added tax which are all nationally levied taxes. The ability of many of the provinces to generate own income is very limited and on average provinces generate about 3 – 4% of their own income.<sup>78</sup> South Africa is a country with huge developmental needs, reflected by large areas of extreme poverty. Although progress has been made with social transformation and economic development during the first decade of South Africa's democracy, South Africa remains a country of extremes; very affluent societies in many urban areas on the one hand and many rural and urban areas of extreme poverty on the other hand.

Industrial development has traditionally happened only in a selected number of areas and often coincided with mining, for example in Gauteng. In an attempt to address this situation of unequal economic development, government has introduced economic or industrial development zones in various provinces. One such area is around Coega in the Eastern Cape. The economic inequality amongst the nine provinces is underlined by the fact that Gauteng is responsible for more than 40% of the country's gross domestic product, while its population accounts for approximately 18% of the country's population.<sup>79</sup> Other provinces with a mostly rural character such as Eastern Cape and Limpopo, face many developmental needs, for example, the building of schools, clinics and roads. The communities are very poor and unemployment is high. It is evident that a great deal of government funding is required in these areas in order to address their needs.

The unique developmental challenges of South Africa have a significant impact on government policy, in particular on the allocation of financial resources to the various spheres of government. Bridging the gap between the rich and the poor and thereby

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<sup>77</sup> There is speculation that the national unemployment figure could be as high as 40%, but the official figure in March 2003 was 31,2%. See National Treasury *Budget Review 2004* 42.

<sup>78</sup> See discussion under **4 3 1**.

<sup>79</sup> National Treasury *Intergovernmental Fiscal Review 2003* 3.

reducing the economic inequality in the country, remains one of the key objectives of the national economic policy. In order to create higher economic growth, more employment and improved social conditions, the national government has increased public spending on aspects such as investment in infrastructure, skills development and school education during the last few years. Addressing the challenges resulting from situations of severe poverty in many areas of South Africa, places high demands on the limited available financial resources and this has a direct impact on the equitable division of revenue. For example, provincial spending on pro-poor social services such as basic health care, housing and education remains a priority and therefore a substantial part of the provincial budgets.<sup>80</sup> The national annual budget is utilised as the most important government tool for the redistribution of wealth in the country.

### **3 6 Conclusion**

The basic economic model for a unitary system of government developed by Musgrave is a useful point of departure for a discussion on public finance. Although the situation is more complex in a multi-level system of government, the principles developed by Musgrave can be utilised. The functions of the Allocation, Distribution and Stabilisation Branches are still applicable in a federal system. It is, however, also evident that the existence of more than one level of government requires the consideration of other essential factors, such as the existence of vertical and horizontal inequalities and the need to redistribute income and wealth among the various jurisdictions.

There is no single economic blueprint for the design of a financial intergovernmental system in a federal or decentralised system of government. Some economic guidelines or principles have been developed and are commonly used in the design of such systems. In accordance with the modern approach to federal systems of government, a wide range of permutations under the umbrella of federal systems is possible and these should apply economic principles in their design.

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<sup>80</sup> National Treasury *Intergovernmental Fiscal Review 2003* 13.

Economic theory with respect to fiscal federalism suggests that expenditure responsibilities and decision-making should be decentralised. In accordance with the economic framework suggested by Oates, welfare will be optimised in a federal system when each level of government is responsible for providing the most efficient level of public goods to the people within its area of jurisdiction.<sup>81</sup> This implies that macro-economic stabilisation, redistribution of income and the provision of those public goods that affect the welfare of all citizens should be centralised. Those public services that can best be provided at a regional or local level and are primarily aimed at the benefiting of the people within a specific area, should be decentralised.

It is evident from the above analyses that two major objectives should be considered in the design of a decentralised system of government, namely efficiency and equity. In terms of economic theory, efficiency requires that the most efficient resource allocation should be obtained. Equity considerations suggest that the resource allocation to various levels of government should be fair and aimed at reducing economic disparities. Equity in the case of South Africa implies that financial resources must be utilised in a manner that will result in bridging the gap between the rich and the poor and improving the quality of life of all people.

In developing a decentralised system of government, the question is; what expenditure responsibilities and revenue sources should be decentralised to regional and local governments, or put differently, what should the extent of decentralisation be? In order to increase accountability and efficiency, the allocation of expenditure responsibilities should match the allocation of revenue sources as closely as possible. This should reduce the need for revenue sharing or intergovernmental grants. It is however inevitable in any decentralised system of government that there will be a need for some form of fiscal equalisation in order to reduce vertical and horizontal inequalities. This can be done by way of particular revenue sharing arrangements or various intergovernmental grants or both. Equity and efficiency considerations are crucial to the development of fiscal equalisation mechanisms.

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<sup>81</sup> Oates *Fiscal Federalism* 37.

In conclusion, economic theory suggests that decentralisation of expenditure responsibilities and revenue sources for the most efficient and equitable results should be the basic premise. The complexities of multi-level government, however, require a balanced approach to the design of decentralised systems of government, including a carefully designed balance of the relevant, and sometimes conflicting, demands on the system. In terms of this approach the benefits of the centralisation of functions can be combined with the benefits of decentralisation to produce the most efficient and equitable solution. Actual economic, financial and political considerations have a significant impact on the eventual design and implementation of financial intergovernmental relations. Financial intergovernmental arrangements should not be seen as the end result, but should be reviewed from time to time, as various factors impact on the design of decentralisation of responsibilities and these change continuously over time.

<b>4</b>	<b>Constitutional division of obligations and allocation of financial resources</b>
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<b>4 2</b>	<b>Constitutional division of obligations</b>
<b>4 2 1</b>	<b>Germany</b>
<b>4 2 2</b>	<b>South Africa</b>
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<b>4 3 4</b>	<b>Interim conclusion</b>
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## **Chapter 4    Constitutional division of obligations and allocation of financial resources**

### **4 1    Introduction**

An important part of this study is the analysis of the division of functions or obligations and the allocation of financial resources to the various levels of government in Germany and South Africa. An obvious question to ask is: What motivated or influenced the current constitutional provisions? Constitutional history is important to any constitutional system and contributes to a better understanding of it. **Chapter 2** provides an overview of the historical development and fundamental principles of the Basic Law and of the South African Constitution. This will lay the foundation for a detailed discussion regarding the actual division of obligations and allocation of financial resources to the various levels of government in both Germany and South Africa.

It is evident from economic theory discussed in **Chapter 3**, that economic considerations and developmental needs provide the basis for the allocation of expenditure responsibilities or functions and revenue resources to the various levels of government in a decentralised system of government. In this chapter, the focus is on constitutional considerations for the allocation of obligations and financial resources

to the various levels or spheres of government in Germany and South Africa. Reference will, however, be made to the role of economic considerations in the development of these two constitutional systems.

The allocation of obligations and financial resources cannot be viewed in isolation. It has to be considered with due reference to the institutions responsible for the performance of functions of government and objectives regarding economic development. Questions such as the following must be answered: What is the scope of the legislative and executive jurisdiction of each level of government, and what financial resources does each level of government have? Although this study is a comparison of the relevant constitutional provisions in the Basic Law and the South African Constitution, considerations that influenced these provisions and the way in which the constitutional provisions operate in practice, will also be discussed.

## **4 2 Constitutional division of obligations**

### **4 2 1 Germany**

One of the most contentious and difficult issues in the debates preceding the drafting of the Basic Law in 1949, was the question of the division of powers and the division of revenue resources between the *Bund* and the *Länder*.<sup>1</sup> During the development of German federalism, balancing the need for political unity and the preservation of the autonomy of the *Länder* was always an issue. This was still the case in the period immediately preceding the adoption of the Basic Law. Decentralization of powers and the strengthening of *Länder* were supported by the *Länder* and by the Western Occupation Forces who were not in favour of a concentration of power at the federal level. However, the dire needs for rebuilding the country devastated by war dictated that most of the taxing powers should be allocated to the *Bund*.<sup>2</sup>

The Herrenchiemsee constitutional convention in August 1948 produced a draft text for a future constitution for (West) Germany. This was presented to the Parliamentary

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<sup>1</sup> The historical development that led to the adoption of the Basic Law in 1949 is discussed under **2 1 1**.

<sup>2</sup> Fischer-Menshausen "Die Abgrenzung der Finanzverantwortung zwischen Bund und Ländern" in *Die Öffentliche Verwaltung* (November 1952) 673.

Council (*Parlamentarischer Rat*) that met in Bonn for debate.<sup>3</sup> The division of powers and the division of revenue resources were fiercely debated in the Parliamentary Council but eventually a compromise was reached. Important considerations that influenced the debates in this Parliamentary Council were:

- ❖ The advancement of a modern economy;
- ❖ The advancement of a welfare state in accordance with the principle of uniformity of living standards (*Einheitlichkeit der Lebensverhältnisse*); and
- ❖ The advancement of the financial autonomy of the *Länder*.<sup>4</sup>

There were opposing views regarding the financial administration system to be adopted. The Occupation Forces argued for a two-tiered financial administration in order to limit the powers of the *Bund*, while the majority in Parliamentary Council wanted a single financial administration to be placed at the federal level. This was not acceptable to the Occupation Forces and their two-tier model of financial administration, namely a separation of powers between the *Bund* and the *Länder*, was adopted.<sup>5</sup> In adopting a model in terms of which there would be a division of powers, in particular with respect to financial matters, it was envisaged that this particular constitutional arrangement would provide both the *Bund* and the *Länder* with sufficient financial powers.

The Basic Law was adopted in the Parliamentary Council on 8 May 1949, ratified by more than two thirds of the *Länder* governments and eventually confirmed in a public session of the Parliamentary Council on 23 May 1949.<sup>6</sup> In terms of the Basic Law there is a vertical division of powers between the *Bund* and the *Länder* and a horizontal division of powers between the legislative, executive and judicial branches of government. In terms of the vertical division of powers, Article 70 of the Basic Law allocates the legislative powers in principle to the *Länder*, however the *Bund* utilized the legislative powers most and the bulk of legislation was thus federal

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<sup>3</sup> Kilper & Lhotta *Föderalismus in der Bundesrepublik Deutschland* (1996) 91; Von Münch *Staatsrecht Band I* (1993) 20.

<sup>4</sup> Kilper & Lhotta *Föderalismus in Deutschland* 97.

<sup>5</sup> Vogel *Grundzüge des Finanzrechts des Grundgesetzes* in Isensee & Kirchhof *Handbuch des Staatsrechts Band IV* (1990) 7.

<sup>6</sup> Basic Law for the Federal Republic of Germany published in the Federal Law Gazette on 23 May 1949; Kilper & Lhotta *Föderalismus in Deutschland* 98.

legislation.<sup>7</sup> Most of the administration of legislation is executed by the *Länder*. This is so for their own laws and in respect of most federal laws.<sup>8</sup>

A fundamental principle in the allocation of obligations and resources is that the *Bund* and the *Länder* should both enjoy a substantial degree of financial autonomy. They should be enabled, within the available resources, to fund all the obligations or duties allocated to them.<sup>9</sup> Art 104a (1) of the Basic Law makes it clear that the *Bund* and the *Länder* should each finance the expenditure resulting from the fulfilment of their respective obligations, except where the Basic Law provides otherwise. Historically the focus of financial power shifted between the *Bund* and the *Länder*. Under the 1871 Constitution of the German Empire, the *Reich* was dependent on the *Länder* that had financial autonomy. The Weimar Constitution in 1919 reversed this position to make the *Reich* financially autonomous by allocating the legislative authority over the most important taxes to the *Reich*.<sup>10</sup> The situation changed again in 1949 with the adoption of the Basic Law. The balanced approach in the Basic Law appears to be an attempt to reconcile two opposing concepts, namely financial autonomy on the one hand and financing of joint responsibilities and financial equalization to ensure uniform living standards on the other hand.<sup>11</sup> Against the background of a country in ruins after World War II, there were also important economic considerations that underpinned constitutional aims. There was a clear need for economic restructuring and rebuilding of the country. The responsibility of the federal government for the payment of war debts required that the balance of the taxing powers should be located at the *Bund*.<sup>12</sup> Improvement of the living standards of all the people was dependent on the creation of enough jobs and the establishment of a social security system that could support those in need. While this was true for the whole country, the territory of Saarland was in a unique situation that warranted special attention. The economy

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<sup>7</sup> Heun *The evolution of federalism* in Starck (ed) *Studies in German Constitutionalism* (1995) 167 177; Leonardy *Intergovernmental Relations in German Federalism* (1994) 19.

<sup>8</sup> Art 70 – 75, 83 – 87 of the Basic Law; Venter *Constitutional Comparison – Japan, Germany, Canada and South Africa as Constitutional States* (2000) 232 – 234; Kilper & Lhotta *Föderalismus in Deutschland* 103; Leonardy *Intergovernmental Relations* 17; Von Münch *Staatsrecht Band I* 20.

<sup>9</sup> Württenberger *The Principle of Subsidiarity as a Constitutional Principle* in Elwein et al (eds) *Jahrbuch zur Staats- und Verwaltungswissenschaft* 7 (1994) 65 71.

<sup>10</sup> Laufer & Münch *Das Föderative System des Bundesrepublik Deutschland* (1997) 50; Vogel *Grundzüge des Finanzrechts* 10.

<sup>11</sup> Vogel *Grundzüge des Finanzrechts* 11.

<sup>12</sup> Fischer-Menshausen *DÖV* 22 (Nov 1952) 673.



of Saarland was heavily dependent on the coal and steel industry, which suffered many job losses after the end of World War II. In addition, Saarland was in an insecure constitutional situation since it was firstly part of the French Zone after the war and later the subject of international treaties between Germany and France before that territory eventually, in 1957, became a *Land* again within the Federal Republic of Germany.<sup>13</sup>

The current allocation of obligations and division of revenue resources in the Basic Law has the following basic features:

- ❖ Most legislative authority is allocated to and utilized by the *Bund*, whereas most federal laws are executed by the *Länder*,<sup>14</sup>
- ❖ the allocation of legislative authority for the most important taxes to the *Bund*, where the *Bundesrat* must consent to any federal bills on taxes to the benefit of *Länder* or municipalities,<sup>15</sup>
- ❖ division of financial administration between the *Bund* and the *Länder*,<sup>16</sup> and
- ❖ horizontal and vertical financial equalization mechanisms.<sup>17</sup>

Von Münch described the *Finanzverfassung* (financial constitution), a term that is often found in German literature and in practice, as consisting of the rules relating to the division of competences between the *Bund* and the *Länder*, the allocation of legislative authority for financial matters to the *Bund* and the *Länder* and the allocation of revenue resources to the *Bund* and the *Länder*.<sup>18</sup> In early literature, the *Finanzverfassung* is defined as the constitutional rules relating to public finance and the tax system of the state and its subdivisions.<sup>19</sup> While it might be useful to have a

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<sup>13</sup> *BVerfGE* 4, 157 (*Saarstatut*); *BVerfGE* 86, 148 247; Laufer & Münch *Das föderative System* 61.

<sup>14</sup> Art 70 - 75 (legislative competences) and Art 83 - 90 (administrative obligations) of the Basic Law; Häde *Finanzausgleich* (1996) 19 – 30; Leonardy *Intergovernmental Relations* 19

<sup>15</sup> Art 105 of the Basic Law; Leonardy *Intergovernmental Relations* 23.

<sup>16</sup> Art 108 of the Basic Law.

<sup>17</sup> Art 106, 106a and 107 of the Basic Law; Häde *Finanzausgleich* 208.

<sup>18</sup> Von Münch *Staatsrecht Band 1* 221; Klein *Bund und Länder nach der Finanzverfassung des Grundgesetzes* in Benda et al (eds) *Handbuch des Verfassungsrechts der Bundesrepublik Deutschland* (1983) 863 - 866. The *Finanzverfassung* of Germany is stipulated in Chapter X (Finance), the relevant provisions in Chapter VII (Federal legislation), the relevant provisions in Chapter VIII (Implementation of federal legislation, federal administration) as well as Chapter VIIIa (Joint responsibilities) of the Basic Law.

<sup>19</sup> Hettlage *Die Finanzverfassung im Rahmen der Staatsverfassung* (1956) 3. See also Vogel *Grundzüge des Finanzrechts* 5.

collective term, such as the *Finanzverfassung*, for the constitutional rules pertaining to the division of competences and allocation of revenue resources, it is the content, meaning and application of these constitutional rules rather than the “label” that is important.

The Basic Law provides that all powers not specifically allocated to the *Bund* are reserved for the *Länder*, including legislative and executive powers.<sup>20</sup> Article 30 stipulates:

“Except as otherwise provided or permitted by this Basic Law the exercise of governmental powers and the discharge of governmental functions shall be incumbent on the *Länder*.”

The legislative authority of the *Bund* and the *Länder* is described as follows in Article 70 (1):

“The *Länder* have the right to legislate in so far as this Basic Law does not confer legislative powers on the Federation.”

Further division of legislative authority is achieved by listing the areas of exclusive federal legislation (Article 73), areas of concurrent legislation (Articles 74 and 74a) and areas of federal framework legislation (Article 75). As far as concurrent legislative authority is concerned, Article 72 (1) provides that the *Länder* may legislate to the extent that the *Bund* has not done so. The Federal Parliament used these provisions extensively since 1949 by passing the bulk of legislation in the country. This entailed a decrease in *Länder* legislative authority.<sup>21</sup> Roman Herzog, a former President of the *Bundesverfassungsgericht* and Federal President, described this as “the undermining of the distribution of federal state authority that has taken place in the last 40 years in the sector of legislation.”<sup>22</sup>

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<sup>20</sup> Art 30 and 70. Häde *Finanzausgleich* (1996) 17 - 19; Currie *The Constitution of the Federal Republic of Germany* (1994) 25; Würtenberger *The Principle of Subsidiarity* 71 - 74.

<sup>21</sup> Laufer & Münch *Das föderative System* 97; Leonardy *Intergovernmental Relations* 19.

<sup>22</sup> Herzog *The Separation and Concentration of Power in the Basic Law* in Kirchhof & Kommers (eds) *Germany and its Basic Law* (1993) 391 394.

The dominance of the *Bund* in the legislative field is balanced to an extent by the dominant position of the *Länder* in the field of administration. In view of the fact that the *Länder* are responsible for the administration of their own legislation and for federal legislation, as if it were their own law, unless the Basic Law provides otherwise, most of the administrative obligations rest with the *Länder*.<sup>23</sup> In general, the administration of those responsibilities that cannot effectively be dealt with by the individual *Länder*, are performed by the *Bund*. This vertical division of administrative responsibility is a clear indication of the relevance of the principle of subsidiarity in German constitutional law.<sup>24</sup>

The allocation of expenditure responsibilities to the *Bund* and the *Länder* respectively is in accordance with the allocation of obligations to them, except where the Basic Law provides otherwise.<sup>25</sup> In other words, in terms of the basic approach of financial autonomy for each level of government, the *Bund* and the *Länder* are separately responsible to fund the exercise of obligations allocated to them. It also means that in principle the *Länder* obligations should not be funded by federal sources and the obligations of the *Bund* should not be funded by *Länder* sources. This approach is in line with economic theory applicable to federal systems, namely that the provision of services by a particular jurisdiction (level of government) should be paid for by that jurisdiction.<sup>26</sup>

The principle that expenditure responsibility follows the allocation of functions or obligations is referred to as the *Konnexitätsprinzip*, loosely translated as the connecting or linking principle, as stipulated in Article 104a of the Basic Law.<sup>27</sup> This means that when the *Länder* administer federal legislation in their own right, in terms of Article 83 of the Basic Law, they must provide the funding for such administration.

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<sup>23</sup> Art 30 and 83 of the Basic Law; Laufer & Münch *Das föderative System* 103.

<sup>24</sup> Fischer-Menshausen *DÖV* 22 (Nov 1952) 676.

<sup>25</sup> Art 104a (1) of the Basic Law. Von Münch *Staatsrecht* (Band I) 221; Fischer-Menshausen *DÖV* 22 (Nov 1952) 675.

<sup>26</sup> See discussion under **3 1**.

<sup>27</sup> Hummel & Nierhaus *Die Neuordnung des bundesstaatlichen Finanzausgleichs im Spannungsfeld zwischen Wachstums- und Verteilungszielen in ifo studien zur finanzpolitik* 54 (1994) 7; Von Münch *Staatsrecht Band I* 221; Vogel *Grundzüge des Finanzrechts* 16. The basic principle is stipulated in Art 104a (1), viz:

This connecting principle demarcates the financing of obligations of the *Bund* and the *Länder* respectively; it also prohibits the financing of expenditure by one level of government on behalf of another level of government.<sup>28</sup> While this is the general rule, there are exceptions to the *Konnexitätsprinzip*. Firstly, when the *Länder* act on behalf of the *Bund*, the latter must provide the funding. The fact that the *Bund* has substantial influence in such matters and can monitor the performance of the *Länder* in executing such functions, provides support for allocating the financing responsibility to the *Bund*.<sup>29</sup> The second exception relates to the implementation of federal cash benefit laws. When the *Länder* are tasked to implement federal laws that involve the disbursement of funds, such funds may be partly or wholly provided by the *Bund*, as is stipulated in law.<sup>30</sup> No maximum contribution by the *Bund* is stipulated in Article 104a (3) and it is possible that the specific federal law can divide the funding responsibility between the *Bund* and the *Länder* by way of fixed percentages. Thirdly, the *Bund* may provide financial assistance to the *Länder* for major investments by them and by municipalities. A federal law may stipulate that financial assistance be given to the *Länder* if the investments are necessary to maintain the economic equilibrium, or to provide equalization of economic capacities or to promote economic growth.<sup>31</sup> An example of such investment programs that attracted financial assistance from the *Bund* is the Structural Assistance Act, 1988. In terms of this a number of *Länder* could get financial support for structural improvement projects to equalize differences in their respective economic performances.

It should be noted that the Basic Law makes specific provision for the financing of joint responsibilities between the *Bund* and the *Länder*, for example, for provisions included as part of the constitutional reform in 1969. Article 91a provides for the participation of the *Bund* in the execution of *Länder* obligations relating to building

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“The Federation and the *Länder* shall separately finance expenditure resulting from the discharge of their respective responsibilities in so far as this Basic Law does not provide otherwise.”

<sup>28</sup> Klein *Bund und Länder nach der Finanzverfassung* 868.

<sup>29</sup> Art 104a (2) and Art 85. Häde *Finanzausgleich* 62; Klein *Bund und Länder nach der Finanzverfassung* 870.

<sup>30</sup> Art 104a (3). Häde *Finanzausgleich* 63 - 66; Klein *Bund und Länder nach der Finanzverfassung* 873.

<sup>31</sup> Art 104a (4). Vogel *Grundzüge des Finanzrechts* 17.

and extending of higher education institutions, improvement of regional economic structures and the improvement of agricultural structures and coastal preservation. The financial involvement of the *Bund* is dependant on the fulfilment of two conditions, namely that the particular programs are relevant to the community as a whole and that federal involvement is necessary in order to improve living conditions.<sup>32</sup> It is further possible that the *Bund* and the *Länder* may conclude agreements for co-operation in any of the following areas; education planning, the promotion of research institutions and projects of supraregional importance. Such agreements specify the exact division of funding responsibilities between the two levels of government.<sup>33</sup> Another way of co-operation between the two levels of government is joint planning between the *Bund* and the *Länder*. This takes place in the planning committees (*Planungsausschüsse*) on joint projects by the *Bund* and the *Länder*.

With respect to the allocation of legislative powers, the Basic Law provides for two types of concurrent jurisdiction, namely the "ordinary" concurrency where the *Bund* and the *Länder* may legislate on the same matter, and areas of federal framework legislation. In the latter case, the *Bund* may enact a framework law on one of the listed areas of jurisdiction with the aim of leaving enough scope for the individual *Länder* to enact supplementary legislation that will "complete" the law, for example legislation on the principles of higher education.<sup>34</sup> Article 72 lays down certain conditions for the enactment of concurrent legislation, that apply to framework legislation. The *Länder* may enact a law in the concurrent field as long as, and to the extent that, the *Bund* does not exercise its legislative powers. On the other hand, the right of the *Bund* to legislate on concurrent matters can only be exercised if any one of the three conditions listed in Article 72 (2) is met, namely;

- (i) the inability of individual *Länder* to effectively regulate a matter; or
- (ii) the possible prejudice of a *Land* law to the interests of other *Länder* or the country as a whole; or
- (iii) the need to maintain legal and economic unity, in particular uniform living conditions in more than one *Land*.

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<sup>32</sup> Art 91a (1) of the Basic Law.

<sup>33</sup> Art 91b of the Basic Law; Bernd Spahn *Financing Federal and State Governments* (1991) 6; Klein *Bund und Länder nach der Finanzverfassung* 876.

The question about the need for federal legislation as stipulated in Article 72 (2) does not place an obligation on the *Bund* to pass a law if any of these conditions is met, but it merely provides the right to the *Bund* to legislate.<sup>35</sup>

The *Länder* play a role in the federal legislative process through their participation in the *Bundesrat*, the second chamber in the Federal Parliament. The *Bundesrat* gives expression to intergovernmental coordination and co-operation because of the fact that it is a federal legislative organ that consists of representatives of the executive of the *Länder*.<sup>36</sup> Depending on the subject of a Bill, the *Bundesrat* must either give its consent (“consent Bills”), for example in case of Bills affecting the constitutional relations between the *Bund* and the *Länder*, or object (“objection Bills”), for example in case of a law on defence matters.<sup>37</sup> Roughly speaking, all Bills relating to the administrative power of *Länder* and those that have financial implications for the *Länder*, are consent Bills, while the rest fall into the category of objection Bills. The *Länder* through their participation in the *Bundesrat*, have a significant influence on the adoption of the legislation that they administer, and therefore also on the funding for the administration of legislation.<sup>38</sup>

The question can be asked whether the fact that the *Bundesrat* must give its consent to a potentially wide range of Bills, does not have a limiting effect on the passing of legislation and the functioning of the constitutional system in Germany? The answer is no. The fact that different political parties may be in the majority in the *Bundesrat* than the party or parties in government, is an implied reality in the German constitutional system. This is the political context within which the constitutional system functions. Constitutional institutions and political parties must adhere to the principle of *Bundestreue* or federal loyalty, and must thus cooperate to uphold the Basic Law.<sup>39</sup> Leonardy, in his discussion of this question, came to the conclusion that

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<sup>34</sup> Von Münch *Staatsrecht Band I* 212.

<sup>35</sup> Von Münch *Staatsrecht Band I* 214 - 216.

<sup>36</sup> Art 50, 51 of the Basic Law, Leonardy *Intergovernmental Relations* 2.

<sup>37</sup> Art 50, Art 104a of the Basic Law; Laufer & Münch *Das föderative System* 124; Leonardy *Intergovernmental Relations* 21.

<sup>38</sup> Leonardy “The *Länder* and the *Bundesrat* today – Co-operative federalism or Gridlock?” 1997 *Politik* 8.

<sup>39</sup> See discussion of *Bundestreue* under 2.3.

*Bundestreue* sets a standard of political behaviour and places a constitutional obligation on political parties and on constitutional institutions to act within the spirit of federal loyalty or “mutual considerateness of each other’s functions.”<sup>40</sup>

#### **4 2 2 South Africa**

The division of powers and functions between the various levels of government in the new constitutional order was one of the most contentious issues during the constitutional negotiations in the early nineties in South Africa. This was mainly because of the conflicting views on centralization and decentralization amongst the negotiating parties.<sup>41</sup> . Part of the debate concerned the creation of new provinces or regions, and their number and size. The Negotiating Council of the Multi-Party Negotiating Process in Kempton Park eventually appointed an independent commission to investigate some issues and to make recommendations on the demarcation of regions in South Africa. In the second half of 1993, the Commission on Demarcation/delimitation of States/Provinces/Regions submitted its report to the Negotiating Council and recommended that nine provinces be created.<sup>42</sup> They based their recommendations on a variety of criteria. These included economic aspects, geographic coherence, institutional and administrative capacity and socio-cultural issues.<sup>43</sup> With respect to economic viability the Commission noted that an economically viable region (province) should have “an economic base to provide jobs, produce goods and services and a sufficient tax base to provide fiscal capacity”.<sup>44</sup> The Commission, however, recommended that although economic viability is important, the critical factor for the demarcation of regions should be economic functionality, or level of economic activity, of the proposed regions. The report formed the basis for the constitutional provisions that established the nine new provinces in South Africa in 1994. The Constitutional Court confirmed that the

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<sup>40</sup> Leonardy 1997 *Politik* 9.

<sup>41</sup> See discussion under **1 1 2** and **1 1 3**.

<sup>42</sup> *Report of the Commission on the Demarcation/Delimitation of SPR's* (1993); Welsh *The Provincial Boundary Demarcation Process* in De Villiers (ed) *Birth of a Constitution* (1994) 223 224. Those provinces were Western Cape, Northern Cape, Orange Free State (now known as Free State), KwaZulu-Natal, Eastern Transvaal (now Mpumalanga), Northern Transvaal (later Northern Province and now Limpopo), PWV (now Gauteng) and North-West Province.

<sup>43</sup> *Report on Demarcation of Regions* 17.

<sup>44</sup> *Report on Demarcation of Regions* 18.

provinces were created by the Constitution and that they received their powers and functions from it.<sup>45</sup>

During the constitutional negotiations, a growing consensus developed between the major political role-players that there should be a new constitutional order in terms of which there would be some form of division of powers between the various levels of government. The exact nature of this division, however, proved to be a very contentious and complex issue and was hotly contested until the final stages of the negotiations.

The 34 Constitutional Principles agreed to in the Multi-Party Negotiating Process provided the framework for the new constitution that was to be adopted by the Constitutional Assembly in 1996.<sup>46</sup> The fact that nine of the Constitutional Principles (XVIII - XXVI) dealt with the constitutional division of competences and obligations between the levels of government and the financial relations between the various spheres, indicates the importance of this aspect. It was very difficult to reach a compromise between the various opposing views on this subject. Although there is no hierarchy of Constitutional Principles, Constitutional Principle XX probably described the duty of the Constitutional Assembly in the clearest terms. It determined that:

"Each level of government shall have appropriate and adequate legislative and executive powers and functions that will enable each level to function effectively. The allocation of powers between different levels of government shall be made on a basis which is conducive to financial viability at each level of government and to effective public administration, and which recognises

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<sup>45</sup> *In re: The National Education Policy Bill No 83 of 1995* 1996 3 SA 289 (CC); 1996 4 BCLR 518 (CC) para 23; *Ex parte Chairperson of the Constitutional Assembly: In re Certification of the Constitution of the Republic of South Africa, 1996* 1996 4 SA 744 (CC); 1996 10 BCLR 1253 (CC) paras 258 – 260; *In re: Certification of the Constitution of the Province of KwaZulu-Natal, 1996* 1996 11 BCLR 1419 (CC) para 14. The provinces were created by the 1993-Constitution and confirmed by the 1996-Constitution.

<sup>46</sup> For a discussion on the role and importance of the Constitutional Principles see 2 2 1 and 2 2 2; De Villiers *The Constitutional Principles – Content and Significance* in De Villiers (ed) *Birth of a Constitution* 37; Venter "Requirements for a new constitutional text: the imperatives of the constitutional principles" in 1995 (32) *SALJ* 32 et seq. The Constitutional Principles are contained in Schedule 4 of the 1993-Constitution.



the need for and promotes national unity and legitimate provincial autonomy and acknowledges cultural diversity."

The Constitutional Principles encompass elements of a federal system without mentioning the word "federalism". It has been argued that the current South African constitutional system falls within the category of integrated or co-operative federal systems. This provides an indication of the relationship between the various spheres of government, namely, a co-operative relationship.<sup>47</sup> The subsidiarity principle, referred to in CP XXI, was also a guiding principle for the design of the new constitution.<sup>48</sup> The allocation of concurrent legislative and executive functions to provincial and national governments and exclusive functions to provinces supports the notion of subsidiarity, in terms of which decisions should be taken at the lowest possible level or, stated differently, functions should be allocated to the level where they can be exercised most efficiently. Van Wyk argued that although the Constitution was not drafted with an express subsidiarity purpose in mind, a number of provisions in the Constitution support the notion of subsidiarity, for example, the provisions regarding the division of competences between the different spheres of government.<sup>49</sup> The application of the subsidiarity principle requires a co-operative relationship among the various levels of government.

Another important consideration that influenced the allocation of financial resources and obligations in terms of the Constitution, was the requirement in Constitutional Principle XXVI that each level of government shall have a constitutional right to an equitable share of revenue. The provinces and local governments were to be placed in a position where they are able to fund the provision of basic services and the

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<sup>47</sup> Simeon "Considerations on the design of federations: the South African constitution in comparative context" in 1998 (13) *SAPL/PR* 42 59; *First Certification Case* para 290: "Intergovernmental co-operation is implicit in any system where powers have been allocated concurrently to different levels of government...". See also *In re: The National Education Policy Bill 83 of 1995* 1996 3 SA 289 (CC), 1996 4 BCLR 518 (CC) para 34.

<sup>48</sup> Carpenter *Co-operative government, devolution of Powers and Subsidiarity: the South African Perspective* in Konrad Adenauer Stiftung *Seminar Report: Subnational Constitutional Governance* (1999) 45 - 53; Simeon 1998 (13) *SAPR/PL* 52. See also *First Certification Case* paras 237 to 244 for a discussion on the meaning of CP XXI. The Constitutional Court concluded in para 252 that the division of functions and powers described in the constitutional text complied with the requirements of CP XXI.1

<sup>49</sup> Van Wyk *Subsidiariteit as waarde wat die oop en demokratiese Suid-Afrikaanse gemeenskap ten grondslag lê* in Carpenter (ed) *Suprema Lex* (1998) 251 262.

execution of the functions allocated to them. This is in line with economic theory applicable to federal systems, in terms of which each jurisdiction should fund the functions it is responsible for.<sup>50</sup> Constitutional Principle XXVI incorporated economic theory into the design of the new Constitution.

The huge economic disparities in South Africa, both between the provinces and within the provinces, also influenced the discussion regarding the allocation of financial resources and obligations to the various levels of government.<sup>51</sup> The urgency to address socio-economic development needs dictated an allocation of financial resources that would ensure redistribution or financial equalization could take place. Macro-economic stability and redistribution of wealth are issues that should be dealt with by the central government.<sup>52</sup>

Economic development considerations played a major role in the development of South Africa's constitutional system.<sup>53</sup> The huge economic imbalances in South Africa is a dominant feature of the country and this warranted serious attention in order to create a constitutional framework that would assist government in dealing with the economic development needs of the country. The importance of economic development, financial equalization and macro-economic stability in a decentralised system of government cannot be over emphasized. These issues were addressed in two key sections in Chapter 13 of the Constitution, namely section 214 (equitable shares and allocations of revenue) and section 227 (national sources of provincial and local government funding).<sup>54</sup> The high priority given to economic development issues in government policy is captured in the following statement by the National Treasury:

“„our budget policies are firmly anchored in the bedrock of our democratic and economic order:

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<sup>50</sup> See discussion under **3 1**.

<sup>51</sup> Momoniat *Fiscal decentralization in South Africa: A practitioner's perspective* (2001) 2; Mokgoro *Interprovincial Fiscal Equalization: The Role of the Financial and Fiscal Commission* in De Villiers (ed) *Birth of a Constitution* (1994) 281 284.

<sup>52</sup> See discussion under **3 1**.

<sup>53</sup> SA Government *Principles governing constitution making* 3; CBM *Multi-tier Fiscal Relations: Financing Regions in South Africa* (1993) 6.

<sup>54</sup> The application of CP XXVI to the new constitutional text is discussed in *First Certification Case* paras 414 to 442.

- The Reconstruction and Development Programme informs public spending priorities and Government's broader social and development policy agenda.
- The Constitution provides a division of functions between national, provincial and local governments and serves as the point of departure for cooperative arrangements between the spheres of government."<sup>55</sup>

In South African constitutional law, unlike in Germany, the term "financial constitution" is not commonly used. The Constitution has a chapter specifically devoted to financial matters, namely Chapter 13. One can describe the South African "financial constitution" as being Chapter 13, constitutional provisions relating to the division of competences between the spheres of government and the financial legislation required in terms of Chapter 13, for example, the annual legislation on the equitable division of revenue and the Budget.<sup>56</sup>

Provinces have original legislative power as well as assigned legislative power.<sup>57</sup> In *Ex Parte Western Cape Provincial Government: In Re DVB Behuising (Pty) Ltd v North West Provincial Government* the Constitutional Court held that a provincial legislature had the authority to amend and repeal its provincial legislation, including legislation assigned to it by the national government.<sup>58</sup> The residual legislative authority rests with Parliament.<sup>59</sup> Schedules 4 (concurrent legislative functional areas) and 5 (exclusive provincial legislative functional areas) of the Constitution list functional areas, that are not clearly defined and which potentially create overlaps, for example, between "regional planning and development" (concurrent functional area) and "provincial planning" (exclusive provincial functional area). According to the Constitutional Court, the constitutional scheme requires that meaningful content must be given to an exclusive provincial functional area "by defining its ambit in a way that

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<sup>55</sup> National Treasury *Budget Review 2003* 2.

<sup>56</sup> Brand "The South African Constitution - Three Crucial Issues for Future Development" in 1998 (2) *Stell LR* 182 188.

<sup>57</sup> Sec 104 (1) (b) of the Constitution; *First Certification Case* paras 258-259; Currie & De Waal *The New Constitutional and Administrative Law* Vol I (2001) 201; Malherbe & Brand *South Africa - Sub-national Constitutional Law* in Alen et al (eds) *Sub-national Constitutional Law* (2001) 49 – 56; Rautenbach & Malherbe *Constitutional Law* (1999) 278 et seq; Chaskalson & Klaaren *Provincial Government* in Chaskalson et al *Constitutional Law of SA* 4-12 et seq.

<sup>58</sup> 2000 4 BCLR 347 (CC).

<sup>59</sup> Sec 44 of the Constitution; *First Certification Case* para 239.

leaves it ordinarily distinct and separate from the potentially overlapping concurrent competences set out in Schedule 4”.<sup>60</sup> This implies that each case of contested concurrent or exclusive legislation must be considered on its own merits in order to give meaningful content to the scope of the relevant functional area.

Section 100 of the Constitution<sup>61</sup> provides for national intervention in provincial executive activities and stipulates as follows:

“When a province cannot or does not fulfil an executive obligation in terms of the Constitution or legislation, the national executive may intervene by taking any appropriate steps to ensure fulfillment of that obligation, including - ...”

Such intervention should only be utilized in limited situations when there is a serious failure of government and should be subject to the principles of co-operative government.<sup>62</sup> This was emphasized by the Constitutional Court when it stated:

“This power of intervention is defined and limited. Outside that limit the exclusive provincial power remains intact and beyond the legislative competences of Parliament.”<sup>63</sup>

In a similar way, provision is made in section 139 for provincial intervention in municipal executive activities. The lack of effective service delivery in many parts in South Africa is a major concern. These intervention provisions have been used where there were serious problems at provincial or municipal government level that negatively influenced the delivery of services to the citizens.<sup>64</sup> The inclusion of sections 100 and 139 in the Constitution implies the possibility that the newly created provinces and municipalities may struggle due to a lack of capacity, and enables the

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<sup>60</sup> *Ex Parte President of the RSA: In re Constitutionality of the Liquor Bill* 2000 1 SA 732 (CC) para 56; Malherbe “Die Drankwetsontwerp: Vooraf kontrole en Grondwetlike gesagsverdeling verder omlyn” in 2000 (63) *THRHR* 321. This judgement is discussed in **7 4 1**.

<sup>61</sup> It was amended by the Constitution of the Republic of South Africa Second Amendment Act, 2003 (Act 3 of 2003).

<sup>62</sup> *First Certification Case* paras 263 – 266; Murray “Municipal integrity and effective government: the Butterworth intervention” 1999 (14) *SAPR/PL* 332 342.

<sup>63</sup> *First Certification Case* para 257; Malherbe 2000 (63) *THRHR* 321 331.

<sup>64</sup> See Murray 1999 (14) *SAPR/PL* 335.

national and provincial governments to intervene through appropriate means to correct such a situation. During the first ten years of democracy it became evident that there are many municipalities and a number of the provinces that simply lack sufficient administrative capacity and professional skills to be effective modern governments. Intervention is a particular mechanism created by the Constitution to deal with this inability or unwillingness of governments to perform their duties. It is aimed at correcting the problem that occurred, but does not address the question regarding the lack of sufficient administrative capacity.

In Germany provision is made in the Basic Law for federal supervision of the implementation of federal legislation by the *Länder*. The Federal Government may, with the consent of the *Bundesrat*, issue general administrative rules and may send commissioners to the *Länder* to ensure implementation of federal legislation.<sup>65</sup>

Section 125 (3) of the Constitution requires the national government to assist provinces to develop the “administrative capacity required for the effective exercise of their powers and performance of their functions referred to in subsection (2)”. National and provincial government have the duty in terms of section 154 (1) to assist municipalities by strengthening their capacity to administer their own affairs, to exercise their powers and to perform the functions allocated to them. Intervention is potentially a drastic measure, that should be used sparingly in order to protect the integrity of the respective spheres of government and to adhere to the constitutional principles of co-operative government. Capacity building and support, from one level or sphere to another, should be utilized more to strengthen the ability of provinces and municipalities to provide a better service for their citizens. The Minister of Finance, Trevor Manuel, has criticized provinces in the past for the underspending of funds allocated in particular for infrastructure development as this has limited the economic growth potential of the country.<sup>66</sup> One reason for this situation is the lack of sufficient administrative capacity and technical and management skills at provincial and local government level.

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<sup>65</sup> Art 84 and 37 of the Basic Law.

<sup>66</sup> National Treasury *Intergovernmental Fiscal Review 2003* 18.

One of the first cases of provincial intervention into local government affairs happened in 1998 when the Eastern Cape Provincial Government intervened in the Butterworth municipality by appointing administrators to manage the municipality.<sup>67</sup> Political disputes, various court cases, a lack of funding due to a payment boycott and poor administrative capacity led to this situation. This case study was a useful testing ground for the application of section 139 of the Constitution. The Eastern Cape Provincial Government and the NCOP had to develop rules that would guide the process. Although section 139 (1) (a) and (b) lists some possible acts of intervention, the question of what is appropriate intervention had to be addressed. What constitutes appropriate steps would depend on the nature of the problem being addressed. The Butterworths case underlines the importance of checks and balances in the intervention process. Section 139 clearly creates a duty for a province to intervene in a municipality under particular circumstances and at the same time requires the national government, the provincial legislature and the NCOP to monitor the situation and to ensure that the province exercises this intervention power correctly.

Murray, in a detailed analysis of the Butterworths intervention process, stated that provincial intervention in municipal affairs must be constitutionally justified and that it should be aimed at finding a balance between the “constitutional imperative to respect the municipality’s integrity” and the need for effective government.<sup>68</sup> Both these factors form an integral part of the framework for government in South Africa and must be respected. A large number of municipalities in South Africa lack sufficient capacity to provide basic services and to perform their obligations. This implies that there is potentially a large scope for provincial intervention to support good governance.<sup>69</sup> There should, however, be a continuous drive to build sufficient capacity at municipal government level to avoid interventions in order to maintain the integrity of the respective spheres of government and to adhere to the principles of co-operative government. This duty to assist and strengthen municipal capacity can be costly and places an additional burden on the financial resources of provinces. Provinces should make provision in their budgets to give effect to their constitutional

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<sup>67</sup> Murray 1999 (14) *SAPR/PL* 332.

<sup>68</sup> 1999 (14) *SAPR/PL* 355.

<sup>69</sup> Murray 1999 (14) *SAPR.PL* 358, 377.

obligation to supervise local government and to strengthen their capacity.<sup>70</sup> The duty to assist provinces requires additional funds from the national government and provision should be made for this.

Municipal councils have a limited legislative role in terms of which they are allocated the authority to make by-laws for the effective administration of matters entrusted to them.<sup>71</sup> By-laws can be on local issues falling within the concurrent and exclusive functional areas listed in Part B of Schedules 4 and 5 of the Constitution. Included are areas such as air pollution, electricity and gas reticulation, fire fighting services (concurrent functional areas) and licensing of dogs and traffic and parking (exclusive provincial functional areas).<sup>72</sup> The legislative authority of local government depends on the scope of its executive powers, and it is not the usual situation where the executive authority follows the legislative powers. This gives a clear indication that municipalities are primarily focused on the delivery of services and not on creating legislation.<sup>73</sup>

Provinces have the constitutional obligation to administer their own provincial legislation. Provinces also have the executive authority to administer national legislation falling within the functional areas listed in Schedules 4 and 5 of the Constitution, but only to the extent that they have the administrative capacity to exercise such executive authority.<sup>74</sup> The expenditure responsibility is implied in the obligation to administer provincial or national legislation. In some cases, for example the payment of stipulated welfare grants in terms of national legislation, provinces are like a conduit for channelling funds to the recipients of such grants. The national government has the obligation to assist provinces in developing the necessary administrative capacity to be effective provincial governments. Such assistance could include training of personnel, additional funding to get specific expertise or seconding

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<sup>70</sup> Sec 139, 154 (1) and 155 (6) & (7) of the Constitution.

<sup>71</sup> Sec 156 (2) of the Constitution; *Executive Council of the Western Cape v Minister of Provincial Affairs and Constitutional Development* 2000 1 SA 661 (CC).

<sup>72</sup> Malherbe & Brand 118 *South Africa – Sub-national Constitutional Law* et seq.

<sup>73</sup> Currie & De Waal *Constitutional and Administrative Law* 217 - 220

<sup>74</sup> Sec 125 (2) (b) and (3) of the Constitution; Malherbe & Brand *South Africa – Sub-national Constitutional Law* 78 – 80; Currie & De Waal *Constitutional and Administrative Law* 258 -259; Rautenbach & Malherbe *Constitutional Law* 286.

personnel to a province for a limited period in order to build the required administrative capacity. Some provinces started with low administrative capacity in 1994 and faced huge challenges to create a new provincial administration. Limpopo and Eastern Cape for example had to incorporate previous homeland administrations and parts of previous provincial administrations.<sup>75</sup> This created a heavy burden for these provinces that have predominantly rural populations. They had to merge different systems, for example different sets of bookkeeping and personnel records, while developing a new functional provincial administration that would serve the people of these provinces.

A further category of provincial executive authority is the administration of national legislation that falls outside the functional areas listed in Schedules 4 and 5, and that was assigned to a province.<sup>76</sup>

The provinces play a role in the national legislative process by way of their participation in the National Council of Provinces (NCOP), a chamber of Parliament that was created to ensure that provincial interests are taken into account in the national sphere of government.<sup>77</sup> The NCOP has 90 members consisting of nine provincial delegations of ten members each.<sup>78</sup> Organised local government may also participate in the debates of the NCOP by appointing a maximum of ten part-time representatives, but these representatives have no voting rights.<sup>79</sup> Each provincial delegation consists of six permanent delegates and four special delegates, who must be members of the provincial legislature. The idea behind the provision for special delegates is that there must be an opportunity for members of the provincial executive to form part of the province's delegation to the NCOP.<sup>80</sup> The special delegates are

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<sup>75</sup> Wehner *Fiscal Federalism in South Africa* (1999) 64.

<sup>76</sup> Sec 125 (2) (c) of the Constitution; *Ex Parte Western Cape Provincial Government: In re DVB Behuising (Pty) Ltd v North West Provincial Government* 2000 4 BCLR 347 (CC). For a discussion on assignment of legislation see Brand *Development of Concurrent Legislation - A New South African Perspective in Subnational Constitutional Governance* (1999) 37 - 44.

<sup>77</sup> Sec 42 (4) of the Constitution. See Murray & Simeon "From Paper to Practice: The National Council of Provinces after its first year" in 1999 (14) *SAPR/PL* 96 - 141 for a useful analysis of the operation of the NCOP; Malherbe "The South African national council of provinces: Trojan horse or white elephant?" 1998 (1) *TSAR* 77.

<sup>78</sup> Sec 60 (2) of the Constitution.

<sup>79</sup> Sec 67 of the Constitution; Currie & De Waal *Constitutional and Administrative Law* 149.

<sup>80</sup> Malherbe & Brand *South Africa – Sub-national Constitutional Law* 36; Currie & De Waal *Constitutional and Administrative Law* 148 – 153; Malherbe 1998 (1) *TSAR* 88.



mostly, but not necessarily, members of the provincial executive. The Premier of a province, or a member of the province's delegation designated by the Premier, leads the province's delegation to the NCOP.<sup>81</sup> The creation of the NCOP followed a study visit by a multi-party delegation from the Constitutional Assembly, late in 1995, to Germany. It is safe to say that this visit had a significant influence on debates about a second legislative chamber in Parliament and on the thinking around co-operative government.<sup>82</sup> The NCOP is loosely modelled on the *Bundesrat*, but there are two important differences. Firstly, the *Bundesrat* is composed of members of the executive of the *Länder*, while the provinces are represented by members of both the legislature and the executive. Secondly, the sixteen *Länder* delegations to the *Bundesrat* differ in size between three and six members, while each province has a delegation of ten members to the NCOP. The NCOP is the embodiment of the notion of co-operative government within the legislative sphere, because it creates the opportunity, and the obligation, for representatives of the national, provincial and, to a lesser extent, local spheres of government to cooperate in the national legislative arena.<sup>83</sup>

Provincial delegations to the NCOP each have one vote, except where the Constitution provides otherwise.<sup>84</sup> In the case of ordinary Bills affecting provinces, for example Bills regarding issues within Schedules 4 or 5, each delegation has one vote.<sup>85</sup> Bills within this category are also discussed by the individual provincial legislatures, who must confer a mandate on their delegation to vote in the NCOP. In case of Bills not affecting provinces, the individual delegates each have a vote and voting takes place along party political lines. Money Bills, which include the annual budget, must be adopted in accordance with the section 75-procedure, that states that the NCOP decides on the basis of individual delegates' votes and that the National Assembly can override the decision of the NCOP with a simple majority.<sup>86</sup>

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<sup>81</sup> Sec 60 (3) of the Constitution.

<sup>82</sup> Malherbe 1998 (1) *TSAR* 82.

<sup>83</sup> Malherbe 1998 (1) *TSAR* 86.

<sup>84</sup> Sec 65 (1) of the Constitution.

<sup>85</sup> Sec 76 of the Constitution; Malherbe & Brand *South Africa – Sub-national Constitutional Law* 38 – 39; Currie & De Waal *Constitutional and Administrative Law* 175 – 178.

<sup>86</sup> Sec 77 (2) of the Constitution.

Provinces, through their participation in the NCOP, are able to influence the adoption of national legislation, in particular where it affects provinces, this includes legislation envisaged in Chapter 13 of the Constitution that affects the financial interests of provinces, such as the annual Division of Revenue Act.<sup>87</sup> In its first few years of existence, the NCOP had to develop its own procedures and establish itself as a unique forum for provincial interests. It has not yet achieved its full potential, but according to Murray and Simeon has the ability to still grow into a meaningful institution that will enrich South Africa's democracy.<sup>88</sup> The accommodation of more political diversity in the NCOP would contribute to strengthening its role in Parliament, but this is not envisaged in the near future. The ability of the various provincial delegations to play a meaningful role could be enhanced by providing them with sufficient technical support both at the NCOP and at their respective provinces. Draft legislation needs to be studied carefully and appropriately qualified staff would add value to the functioning of provincial delegations at the NCOP.

In the areas of concurrent jurisdiction, there is nothing in the Constitution that provides a pre-emptive right to pass legislation in either Parliament or a provincial legislature.<sup>89</sup> Both institutions have an equal opportunity to legislate on concurrent matters. It should, however, be noted that there are extensive conflict regulatory provisions in section 146 of the Constitution. These apply when there is a conflict between national and provincial legislation while dealing with a matter that falls within Schedule 4 (concurrent functional areas).<sup>90</sup> In terms of these provisions, a national law will only prevail if it complies with a number of conditions, such as the necessity to have national legislation for the maintenance of economic unity or national security. The application of these conflict regulatory provisions is objectively justiciable in a court of law.<sup>91</sup> Concurrence thus creates the possibility of national as well as provincial legislation in the same functional area, for example

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<sup>87</sup> Sec 75 (ordinary bills not affecting provinces) and sec 76 (ordinary bills affecting provinces) of the Constitution. See Venter *Constitutional Comparison* 247 – 249; Rautenbach & Malherbe *Constitutional Law* 179 - 180.

<sup>88</sup> 1999 (1) *SAPR/PL* 130.

<sup>89</sup> Brand *Concurrent legislation* 37 et seq.

<sup>90</sup> Rautenbach & Malherbe *Constitutional Law* 277 - 279.

<sup>91</sup> *In re Certification of the Amended Text of the Constitution of the Republic of South Africa, 1996* 1997 2 SA 97 (CC) para 155.

education, which in turn has an impact on the expenditure needs of both the national and the provincial (education) departments.

The principles of co-operative government listed in Chapter 3 of the Constitution provide the lubrication for the engine of government in South Africa.<sup>92</sup> They guide the exercise of intergovernmental relations in South Africa and each sphere of government must exercise its powers and fulfil its obligations subject to the principles of co-operative government.

#### **4 2 3 Interim conclusions**

An important historical difference in the development of the current constitutional order in the two country studies is that Germany followed partly a “bottom up” approach in the design of their system, as there were *Länder* before 1949, although some were created by the Basic Law. The opposite occurred in the case of South Africa, where a “top down” approach was followed with the new Constitution that created nine new provinces in 1994. This historical difference had an impact on the further development of the constitutional systems in both countries. Many of South Africa’s provinces started with a capacity deficit due to the huge burden of incorporating various old homeland and provincial administrations. The shortage of skills and administrative capacity that still exists after ten years of democracy has slowed down the growth of provincial government in South Africa.

It appears from the overview of the allocation of legislative competences to the *Bund* and the *Länder*, that there is little scope for *Länder* legislation, although the *Länder* have a substantial influence on federal legislation through their participation in the *Bundesrat*, in particular on legislation that affects the financial position of the *Länder*. The opposite situation exists as far as the allocation of administrative obligations is concerned. The division of competences between the *Bund* and the *Länder* in terms of the Basic Law is sometimes referred to as “executive federalism” in view of this

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<sup>92</sup> See discussion under 2 3; see also Bray “The constitutional concept of co-operative government and its application in education” in 2002 (65) *THRHR* 514; *First Certification Case* para 469; *Liquor Bill Case* para 40 – 41; *Premier of the Western Cape v President of the RSA* 1999 4 BCLR 382 (CC) para 58.

particular division of executive obligations.<sup>93</sup> The fact that the *Länder* carry the bulk of the administrative obligations requires that there should be proper funding arrangements in terms of Article 104 (5) of the Basic Law, whether it be through own or shared sources of revenue or some financial equalization mechanisms.

It is evident that provinces in South Africa, similar to the position of the *Länder* in Germany, have extensive executive responsibilities, whereas the national government is responsible for most of the policy formulation and legislative activity in the country. Provinces are responsible for most of the administration of national and provincial legislation. Due to the particular constitutional division of functions in South Africa, the bulk of provincial obligations fall within the concurrent areas of jurisdiction. Education, health and social services, which are all concurrent functional areas, account on average for approximately 80% of provincial expenditure.

The NCOP has not yet lived up to the constitutional expectations of an important legislative chamber where provincial interests should be reflected. Provinces have not asserted themselves in the NCOP, contrary to the effective role that the *Länder* play in the *Bundesrat*.

### **4 3 Allocation of financial resources**

#### **4 3 1 Legislative authority to levy taxes**

Fiscal federalism entails the division of expenditure responsibilities on the one hand and the division of revenue on the other, between the respective constituent governments, and the allocation of the legislative authority to levy taxes. There is no rule that in federal systems the legislative authority to levy taxes should be allocated to either the national or the provincial governments. There are however several possibilities for different constitutional systems that fall within the broad category of federal or decentralized systems of government.

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<sup>93</sup> Häde *Finanzausgleich* 44.

In the case of Germany, historical factors had an important influence on the current shape of the provisions governing the distribution of the taxing responsibility. A significant part of the financial system created by the formation of the German *Reich* in 1871 was the introduction of federal taxes. The *Reich* had the legislative authority on customs duties and on excise taxes on important consumer goods such as tobacco, salt and sugar.<sup>94</sup> Some *Länder*, such as Bavaria and Württemberg, retained their right to legislate on excise taxes on brandy and beer.

Legislative authority for direct taxes, such as income tax, stayed with the *Länder* until early in the twentieth century when it passed to the *Bund*. Radical changes to the tax system were necessitated by the dire financial position of the state after World War I. The new economic realities that faced the new state required a new approach to the allocation of taxes. The huge amount of funds needed to rebuild the country was enough cause for centralization of the tax system.<sup>95</sup> The Weimar Constitution made provision that the *Bund* will have legislative authority for taxation in order to fulfil its constitutional obligations.<sup>96</sup> The need for federal taxes and expenditure responsibilities was even more evident after World War II when the structural and social needs caused by the War were regarded as a federal concern. Special provision was made in the Basic Law that the *Bund* will be responsible for the expenditure relating to occupation costs and other war burdens.<sup>97</sup> The economic reality of high federal debt and the increased need for social support on a countrywide basis, warranted that the *Bund* be given the authority to raise the major taxes, such as personal income and corporate tax. Another factor that contributed to the dominant position of the *Bund* as far as taxes is concerned, was the fact that it could provide some form of financial equalization across *Länder* boundaries.<sup>98</sup>

The original focus in 1949, largely influenced by the Western Occupation Forces, was to create a clear division of powers between the two levels of government, and not to focus on co-operative elements.<sup>99</sup> In terms of the current provisions in the Basic Law,

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<sup>94</sup> Art 35 *Verfassung des Deutschen Reichs*, 1871; Bundesministerium der Finanzen *An ABC of Taxes in the Federal Republic of Germany* (1997) 16.

<sup>95</sup> Bundesministerium der Finanzen *An ABC of Taxes* 17; Laufer & Münch *Das föderative System* 49..

<sup>96</sup> Art 8 Weimar Constitution, 1919.

<sup>97</sup> Art 120 of the Basic Law; Fischer-Menshausen *DÖV* 22 (Nov 1952) 673.

<sup>98</sup> Fischer-Menshausen *DÖV* 22 (Nov 1952) 673.

<sup>99</sup> Fischer-Menshausen *Das Finanzwesen in Von Münch Grundgesetzkommentar* (1996) 871 876.

the bulk of legislative authority on taxes is allocated to the *Bund*. Article 105, regulating the legislative authority on taxes, is a *lex specialis* on the general legislative authority contained in Article 70 of the Basic Law. Exclusive federal legislative authority is provided in Article 105 (1) over customs duties (*Zölle*) and fiscal monopolies (*Finanzmonopole*).<sup>100</sup> In view of the development of a common internal market in the European Union and the consequential abolition of customs duties within the internal market, this provision is not so significant anymore.<sup>101</sup>

Concurrent legislative authority is allocated to the *Bund* and the *Länder* in Article 105 (2) of the Basic Law to legislate on all other taxes, the revenue of which accrues wholly or in part to the *Bund*, or where the conditions for federal legislation in the concurrent field apply. This provision forms the nucleus on legislative authority to impose taxes since it relates to the most important taxes in Germany. In terms of the first requirement for concurrent federal legislative authority, the *Bund* may inter alia legislate on income tax, corporate tax and turnover tax which all accrue jointly to the *Bund* and the *Länder*.<sup>102</sup> Federal authority over these taxes is substantiated by the second requirement contained in Article 105 (2), namely the conditions applicable to concurrent legislative authority contained in Article 72 (2) of the Basic Law.<sup>103</sup> The need for the maintenance of legal and economic unity, referred to in Article 72 (2) is a strong motivation for locating the major taxes at the federal level. The practical consequence of the application of these two Articles is that all the major taxes in Germany are federal taxes.

It is, however, important to note that the Basic Law gives the *Länder* an important say in this legislative process. Article 105 (3) presents the *Länder* through their participation in the *Bundesrat* with a veto, since the consent of the *Bundesrat* is required for all federal legislation on taxes the revenue from which accrues wholly or in part to the *Länder* or the municipalities. This is quite a significant collective power

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<sup>100</sup> Häde *Finanzausgleich* 154 - 156; Currie *Constitution of Germany* 53; Von Münch *Staatsrecht Band I* 222. Traditionally there were income producing state enterprises in goods such as matches and brandy, but today there is only a fiscal monopoly on brandy. No new fiscal monopolies may be created in view of the protection of freedom of occupation in Art 12 of the Basic Law as well as provisions in the EU competition law.

<sup>101</sup> Laufer & Münch *Das föderative System* 153.

<sup>102</sup> Art 106 (3) of the Basic Law. See Häde *Finanzausgleich* 159.

<sup>103</sup> Häde *Finanzausgleich* 159; Currie *Constitution of Germany* 53; Klein *Bund und Länder nach der Finanzverfassung* 882.

that the *Länder* have in the federal legislative process.<sup>104</sup> The fact that the *Länder* do not have the legislative authority over important taxes such as personal income tax is partly offset by the fact that they play a key role in the federal legislative process when decisions are taken about federal taxes and other fiscal issues. While this is a meaningful constitutional arrangement that provides the *Länder* with a potentially strong power, the question whether the veto power of the *Bundesrat* cannot be misused to block important financial legislation is valid. In terms of the current division of political parties (2003) in Germany the main opposition party, the Christian Democratic Union/Christian Social Union, is in the majority in the *Bundesrat* and can effectively veto legislative proposals by the Social Democratic Party coalition in government, or use its position to bargain for concessions in the proposed legislation before Parliament. While the German economy is struggling and the ageing population places high demands on the pension and health systems, there is a need for a wide range of reform measures that require the support of the *Bundesrat* as well. Some commentators suggest that it is a stalemate where it is difficult to get any decisions taken.<sup>105</sup>

The Basic Law assigns exclusive legislative authority to the *Länder* in terms of Article 105 (2a) to legislate on local excise taxes as long and in so far as they are not identical to federally imposed taxes.<sup>106</sup> Examples of these *Länder* own taxes are hunting and fishing tax, beverage tax and entertainment tax.<sup>107</sup> Although these taxes have a geographical element and are thus relevant for particular individual *Länder*, they are not the main sources of tax revenue for the *Länder*. The scope of these taxes is in fact fairly limited.

Many debates were entertained during 1995 - 1996 on the issue of a restructuring of the legislative competences over taxes. Some, like the Federal Minister of Finance at the time, Theo Waigel, argued for more *Länder* tax autonomy with a view to giving them more responsibility over income and corporate tax. The fact that the *Bund* saw itself as the funder for the unification of Germany implied at least a potential loss of

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<sup>104</sup> Häde *Finanzausgleich* 159; Klein *Bund und Länder nach der Finanzverfassung* 883.

<sup>105</sup> Schultze "German federalism at the crossroads" 2003 (Vol 3 Nr 3) *Federations* 13 15.

<sup>106</sup> This provision was included in the Basic Law as part of the financial reform in 1969.

<sup>107</sup> Von Münch *Grundgesetzkommentar* 789; Klein *Bund und Länder nach der Finanzverfassung* 882.

tax income to the old *Länder*. This stimulated the debate about tax reform, a debate that occurs from time to time when *Länder* feel that their relative financial autonomy is under threat. The situation, however, remains that the *Bund* has the legislative authority over the major taxes.<sup>108</sup>

The Unification of Germany in 1990 required specific financial arrangements in order to finance the huge needs of the new *Länder*.<sup>109</sup> On the taxation side a special tax, called the solidarity surcharge (*Solidaritätszuschlag*) was instituted from 1 January 1995.<sup>110</sup> This surcharge is payable on all income and corporate tax and the revenue is allocated to the *Bund*, that utilizes it for contributing to the economic reconstruction of the new *Länder*.

**Table 4 1      Legislative authority to levy taxes in Germany<sup>111</sup>**

Assignment of legislative authority in terms of Article 105 of the Basic Law		
	<u>To the <i>Bund</i></u>	<u>To the <i>Länder</i></u>
Exclusive power to legislate on customs duties and fiscal monopolies	Concurrent power to legislate on the remaining taxes if the <i>Bund</i> is entitled to the whole or a part of the proceeds; or the conditions for federal legislation in the concurrent field apply	Power to legislate - if the conditions for concurrent legislation by the <i>Bund</i> are not fulfilled; - insofar as the <i>Bund</i> does not exercise its powers of concurrent legislation; - on local excise taxes, insofar as they are not identical with taxes imposed by federal legislation; and

<sup>108</sup> Laufer & Münch *Das föderative System* 155.

<sup>109</sup> See discussions under **5 5**.

<sup>110</sup> Art 31 FKPG (Gesetz zur Umsetzung des Föderalen Konsolidierungsprogramms von 23. Juni 1993 BGBl 1 944); Bundesministerium der Finanzen *Steuern von A bis Z* (2001) 90; Renzsch "Neuregelung der Bund/Länder-Finanzbeziehungen: Volle Einbeziehung der neuen Länder ab 1995" in *Gegenwartskunde* 1/1994 75 79. The rate of the surcharge was initially 7,5%, but was changed in 1998 to the current 5,5%.

<sup>111</sup> Bundesministerium der Finanzen *An ABC of Taxes in the Federal Republic of Germany* (1997) 50.



- on church tax (Article  
140 of the Basic Law)<sup>112</sup>

In the case of South Africa the current division of legislative authority regarding taxes was also influenced by historical developments and political and economic realities. Before 1994, South Africa had a centralised system of government and taxes were thus centralised. Parliament had the authority to legislate on all taxes, except for municipalities who could levy property rates. In 1992 the national government collected about 86% of the total tax revenues in the country.<sup>113</sup> The creation of a new constitutional system in which provinces were to become important constitutional entities posed a challenge to the negotiators and drafters of the constitution to design a new fiscal intergovernmental relations system. Aims such as national unity and provincial autonomy had to be taken into consideration in this process. In their proposals to the Multi-Party Negotiating Process, some of the political parties indicated the need for a balanced approach that would make provision for appropriate financial resources to the national and regional levels of government, including a division of the power to raise taxes.<sup>114</sup> In one of the discussion papers presented to the Multi-party Negotiation Process (MPNP) at Kempton Park two basic options were contrasted, namely a detailed shared tax system in terms of which the provinces would be entitled to a range of shares in a variety of taxes on the one hand versus an entitlement to the regional level of government to a minimum share of all nationally collected taxes.<sup>115</sup> The result of the negotiations at Kempton Park was the inclusion of a tax system, which was effectively a combination of these two proposals. Provinces were given a right to an equitable share of specified taxes, which in turn was mainly composed of percentages to be fixed by an Act of Parliament.<sup>116</sup>

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<sup>112</sup> Häde *Finanzausgleich* 177.

<sup>113</sup> Mokgoro *Interprovincial Fiscal Equalisation* 282.

<sup>114</sup> SA Government *Principles governing constitution making in South Africa* 2; ANC *Regional Policy* - submission to the Technical Committee on Constitutional Issues (May 1993) 12; DP *Submission to the Technical Committee on Constitutional Issues* 4.

<sup>115</sup> CBM *Multi-tier Fiscal Relations: Financing Regions in South Africa* (1993) 14.

<sup>116</sup> Sec 155 (1) and (2) of the 1993-Constitution:

“(1) A province shall be entitled to an equitable share of revenue collected nationally to enable it to provide services and to exercise and perform its powers and functions.

(2) The equitable share of revenue referred to in subsection (1) shall consist of –

(a) a percentage, as fixed by an Act of Parliament, of income tax on individuals which is collected nationally;

(b) a percentage, as fixed by an Act of Parliament, of value-added tax or other sales tax which is collected nationally;

Provision was also made for provinces to raise taxes, levies and duties other than income tax, value-added tax or sales tax, and to impose surcharges on taxes. This was quite a limited scope of legislative authority given to provinces to develop their own tax sources. The legislative authority on taxes was even further limited by the condition that taxes levied by provinces should not be detrimental to national economic policies, interprovincial commerce, or the national mobility of goods, services, capital and labour.<sup>117</sup> Provinces do not have equal tax bases due to the fact that the main centres of the economy are in three of the nine provinces, namely, Gauteng, Western Cape and KwaZulu-Natal. The allocation of significant taxing powers to the provinces would thus have strengthened this inequitable economic situation. The distribution of tax raising powers was done in such a way that the national government retained the legislative authority over the major taxes, such as personal and corporate income tax and value-added tax, while provinces could raise taxes other than these major taxes and could impose a surcharge on taxes if authorised by an Act of Parliament to do so.<sup>118</sup> Although the provinces were not allocated the legislative authority over substantial own sources of revenue, the fact that a fixed percentage of specified national taxes was constitutionally guaranteed served as some counterbalance to the provinces to alleviate the vertical fiscal imbalance.

There were also compelling economic reasons that supported the approach taken in the drafting of the 1993-Constitution. These reasons included the need to provide basic services to various communities throughout South Africa to alleviate poverty and the need for macro-economic stability. The existence of horizontal fiscal inequalities between the various provinces right from their inception and the obvious need to address it posed a challenge to the creation of the new system of financial intergovernmental relations.<sup>119</sup> It appears that national concerns, in particular the need to address horizontal imbalances and the promotion of national unity, had an important influence on the design of the tax system. Centralization of the legislative

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(c) a percentage, as fixed by an Act of Parliament, of any national levy on the sale of fuel;  
 (d) any transfer duty, collected nationally, on the acquisition, sale or transfer of any property situated within the province concerned; and  
 (e) any other conditional or unconditional allocations out of national revenue to a province.”

<sup>117</sup> Sec 156 (2) of the 1993-Constitution. See Mokgoro *Interprovincial Fiscal Equalization* 281 283.

<sup>118</sup> Sec 156 (1) of the 1993-Constitution.

<sup>119</sup> Mokgoro *Interprovincial Fiscal Equalization* 284.

authority over the major taxes is in line with economic theory on decentralized systems of government that state that powers relating to macro-economic stability and redistribution of finances should be allocated at the national level of government.<sup>120</sup>

In the development of the current Constitution, the Financial and Fiscal Commission<sup>121</sup> that played an influential role in the creation of the current financial intergovernmental relations system, argued that a balance had to be achieved between the competing aims of nation building and fiscal autonomy.<sup>122</sup> An important underlying aim of the new fiscal system was to encourage accountability of all levels of government. This implied that ideally each level of government should raise its own revenue needed to fund its constitutional functions. If sufficient financial resources are not allocated to provincial and local governments, it must be supplemented by some form of revenue sharing. The Financial and Fiscal Commission also suggested that other norms, such as equity in the provision of public services and the certainty of revenue and administrative efficiency, should be taken into account in the eventual allocation of financial resources.<sup>123</sup>

In South African society the importance of nation building cannot be underestimated; this is acknowledged in the Preamble and section 1 of the Constitution. Nation building is not a precise concept, but refers to the notion of building a new South African nation by bringing together people from diverse backgrounds and communities with a view to overcome the legacy of apartheid.<sup>124</sup> One of the objectives listed in the Preamble to the Constitution is to “build a united and democratic South Africa able to take its rightful place as a sovereign state in the family of nations”. In economic terms, this aim includes redistribution of financial resources to alleviate poverty and to contribute to economic growth throughout the country. Nation building was a key political objective of the newly elected

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<sup>120</sup> Mokgoro *Interprovincial Fiscal Equalization* 283; Oates *Federalism and Government Finance* in Quigley & Smolensky (eds) *Modern Public Finance* (1994) 131. See also the discussion of allocation of revenue responsibilities under **3.3**.

<sup>121</sup> The FFC was established by sec 198 of the 1993-Constitution and reconfirmed by sec 220 of the 1996-Constitution. In terms of sec 220 (3) the FFC must function in terms of an Act of Parliament and this Act is the Financial and Fiscal Commission Act, 99 of 1997.

<sup>122</sup> Visser & Erasmus *The Management of Public Finance – A Practical Guide* (2002) 262; FFC *Framework Document for Intergovernmental Fiscal Relations in South Africa* (1995) 5, 7.

<sup>123</sup> FFC *Framework Document for Intergovernmental Fiscal Relations in South Africa* 9.

<sup>124</sup> FFC *Intergovernmental Fiscal Relations in SA* 5.

government in 1994, and has been actively pursued since then. The design of a financial intergovernmental relations system is a careful balancing act between the opposing aims of fiscal autonomy and nation building.<sup>125</sup>

The aim of fiscal decentralization fosters the development of responsible government at all levels and it also allows for differentiation at regional government level.<sup>126</sup> Fiscal decentralization has the potential to strengthen good governance values such as accountability and public participation and to accommodate diversity if the respective provinces have sufficient administrative capacity to educate the citizens about their developmental needs and their preferences regarding the delivery of services.<sup>127</sup> All these considerations played a role when the Constitutional Assembly considered the constitutional provisions regarding the legislative authority on taxes. The scheme created under the 1993-Constitution was continued under the current Constitution, while certain amendments were made in an attempt to balance competing norms and other important issues. The most important change was the inclusion of a constitutionally entrenched right of provinces to levy taxes, in contrast to the rather weak provision in the 1993-Constitution that created a limited and qualified scope to raise own taxes at the provincial level.<sup>128</sup>

The basic premise in Chapter 13 (Finance) of the Constitution is that each government within all three spheres of government should be in a financial position to perform the functions allocated to them. Proper funding arrangements, whether by way of own or shared sources and some equalization mechanisms are thus envisaged. Chapter 13 determines the provincial and municipal legislative authority regarding taxes with reference to national taxes, although the national legislative authority is not listed. Provinces may impose taxes, levies and duties other than national and municipal taxes and may impose flat-rate surcharges on certain nationally levied taxes, levies and duties.<sup>129</sup> Provinces are also allowed to impose user fees.<sup>130</sup> The right of provinces

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<sup>125</sup> Murray & Simeon 2000 (15) *SAPR/PL* 496; *FFC Intergovernmental Fiscal Relations* 9.

<sup>126</sup> Oates *Federalism and Government Finance* 131.

<sup>127</sup> Ajam *The evolution of devolution: fiscal decentralization in South Africa* in Abedian & Biggs (eds) *Economic globalisation and fiscal policy* (1998) 54 94.

<sup>128</sup> Chaskalson & Klaaren *Provincial Government* 4-19.

<sup>129</sup> Sec 228 (1) of the Constitution.

<sup>130</sup> *First Certification Case* para 438.

to legislate on taxes is limited by the Constitution, namely it may not be exercised in such a way that materially and unreasonably prejudices national economic policies, cross-provincial economic activities or the national mobility of goods, services, capital or labour. It must also be regulated by an Act of Parliament, and in 2001, such an Act, namely the Provincial Tax Regulation Process Act, 53 of 2001, was adopted by Parliament.<sup>131</sup>

Provincial taxes would mostly benefit the economically stronger provinces such as Gauteng and the Western Cape. This requires that the needs of those provinces with below average tax raising capacity should be considered in the financial equalization process. The approach of the National Treasury towards provincial taxes is that the national government should maintain firm control and approve any provincial tax before a province can institute it.<sup>132</sup> This approach is reflected in the Provincial Tax Regulation Process Act, which requires a province to submit a proposal for a new provincial tax to the Minister of Finance who must, after consideration and consultation with the Budget Council, publish a further Bill to regulate the proposed provincial tax. Only after that is done may a province impose a provincial tax by way of a provincial law. The scheme of the Act, in particular the dominant role given to the national Minister of Finance on a matter that falls within the constitutionally allocated powers of a province, is questionable, since it creates the impression that this Act goes beyond mere “regulation”, as required in section 228 (2) of the Constitution, and in fact encroaches on the right of a province to impose taxes, levies and duties.<sup>133</sup> The Constitutional Court stated in the *First Certification Case* with reference to section 228, that this section gives provinces specific and guaranteed taxing powers and that the national legislation envisaged by section 228 (2) is “to ensure the coherence of the taxing system”.<sup>134</sup> This Act has not yet been utilized by any province; however, some provinces are considering various tax options, for example during 2003 the Western Cape started a process to investigate the possible introduction of a tourism bed levy and a fuel levy.<sup>135</sup>

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<sup>131</sup> Sec 228 (2) of the Constitution. This Act was assented to on 4 December 2001 and published in Government Gazette No 22918 of 10 December 2001

<sup>132</sup> Momoniat *Fiscal decentralization in South Africa* 7.

<sup>133</sup> Murray & Simeon “South Africa’s financial constitution: towards better delivery?” in 2000 (15) *SAPR/PL* 477 482.

<sup>134</sup> *First Certification Case* para 439.

<sup>135</sup> Western Cape Provincial Treasury *Budget Speech 2003* 21.

The Constitution makes specific provision in section 229 for the fiscal powers and functions of municipalities. Municipal own sources of revenue are mainly property rates and surcharges on fees for provision of electricity and water. Municipalities may impose rates on property and surcharges on fees for services rendered by them or on their behalf.<sup>136</sup> There are, however, some constraints applicable to the implementation of this competence, for example it may not materially prejudice national economic policies, and it may also be regulated by national legislation.<sup>137</sup> It is further provided by the Constitution in section 229 (1) (b) that if allowed by national legislation, municipalities may also impose other taxes, levies and duties appropriate to local government, but excluding income tax, sales tax or value-added tax and customs duty.

**Table 4 2      Legislative authority to levy taxes in South Africa**

Assignment of legislative authority in terms of section 228 of the Constitution	
<u>To the national government</u>	<u>To the provinces</u>
Exclusive power to legislate on:	Exclusive power to legislate on:
Personal income tax,	taxes, levies and duties other than
corporate tax,	income tax, value-added tax,
value-added tax,	general sales tax, rates on
general sales tax, and	property or customs duties; and
customs duties.	flat-rate surcharges on any
	nationally imposed tax, levy or
Power to regulate a province's	duty except corporate income
right to impose taxes, levies,	tax, value-added tax, rates on
duties and surcharges	property or customs duties

Provincial taxes account on average for approximately 4 % of total provincial revenue, while the balance is obtained by way of the equitable share of nationally collected revenue. These own sources of revenue include motor vehicle licenses, tax on horse racing and tax on casinos. The development of more own sources of revenue

<sup>136</sup> Sec 229 (1) of the Constitution.

<sup>137</sup> Sec 229 (2) and (3) of the Constitution.

is a continuous point of debate in South Africa. Since 1997 two main schools of thought regarding a provincial surcharge on a national tax base have emerged. On the one hand, the Katz Commission of Inquiry proposed a provincial surcharge on the national fuel levy.<sup>138</sup> The Financial and Fiscal Commission on the other hand has suggested, on more than one occasion, that tax room should be created in order to allow for provinces to levy a surcharge on personal income tax.<sup>139</sup> This proposal included the creation of tax room by the national government to ensure an overall limit of the level of taxation, which means that the national government would have to lower the maximum rate of personal income tax. The Budget Council under the guidance of the Minister of Finance during 2000 rejected this proposal by the FFC.<sup>140</sup> Both the above proposals could provide a source of own revenue for provinces and could contribute to fiscally accountable government. Both are also linked to economic growth and thus provide an incentive for provinces to promote the economy within their respective jurisdictions. It is unfortunate that neither of these proposals have so far been accepted or implemented.

In the case of municipalities, the situation is the opposite to that in provinces since they collect most of their revenue by way of property rates and surcharges or user fees for services such as water and electricity. Many municipalities buy services and goods such as electricity and water in bulk and then resell it to the inhabitants of that area at a higher price. Local government collectively and not individual municipalities are entitled to an equitable share of the nationally collected revenue.

The electricity distribution industry in South Africa is currently undergoing a major reconstruction process, that involves all municipalities and Eskom, the national electricity supplier. The view of the national government is that the current arrangements regarding distribution of electricity in South Africa are financially unsustainable, inefficient and inequitable.<sup>141</sup> Evidence of the critical financial

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<sup>138</sup> The Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa led by Prof. Michael Katz.

<sup>139</sup> FFC *Recommendation and Comments – the Allocation of Financial Resources to National, Provincial and Local Governments for the 1998/99 Fiscal Year* (1998) 25 et seq. See also Wehner *Fiscal Federalism in South Africa* 70; Murray & Simeon “South Africa’s financial constitution” 482.

<sup>140</sup> National Treasury *Intergovernmental Fiscal Review 2000* 73

<sup>141</sup> Department of Minerals and Energy *Electricity Distribution Industry Restructuring Blueprint Report* (February 2001) 4.

situation is presented by the fact that many municipalities that distribute electricity to consumers have suffered severe financial losses during the last few years.<sup>142</sup> It is envisaged that the restructuring process will result in the establishment of six regional electricity distributors (RED's) for the whole country. Eskom and the municipalities will be shareholders in these new electricity distribution companies.

It is evident that this process will have an impact on municipalities, both as far as expenditure for the delivery of services is concerned, and as far as the income of the municipalities is concerned. The Department of Minerals and Energy recognizes this fact and have proposed that there should be special arrangements to provide for the maintenance of the current levels of financial transfers from electricity services to municipalities.<sup>143</sup> The total impact on local government finances however remains to be seen.

Municipalities are responsible for the delivery of water and sanitation services within their area of jurisdiction and they also receive revenue from the provision of these services. The service is subsidized by the national government in order to implement the national policy of provision of free basic water services to the public. This has meant that a conditional grant (Municipal Infrastructure Grant) has been allocated to local government within each province to finance the development of the infrastructure required for the provision of basic services, such as water and sanitation, to poor households.<sup>144</sup> Without such a specific allocation to fund the provision of basic services so desperately needed by the community, it would be extremely difficult for municipalities to improve the quality of life of poor people.

Provinces have a limited legislative competence to impose taxes in view of the fact that the major taxes are governed by national legislation. However, in the national legislative process provinces, through their participation in the National Council of Provinces, have an influence on the adoption of national legislation envisaged in

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<sup>142</sup> Department of Minerals and Energy *EDI Restructuring Report 2*.

<sup>143</sup> Department of Minerals and Energy *EDI Restructuring Report 12*.

<sup>144</sup> See for example Schedule 4 of the Division of Revenue Act, 7 of 2003.



Chapter 13 of the Constitution and this affects the financial interests of provinces.<sup>145</sup> This is not insignificant as it also includes the Act of Parliament that determines the equitable division of revenue.<sup>146</sup> In practice this potential for more provincial involvement in the national legislative process has not been fully explored yet. This is due to various practical factors including the limited time and research capacity in the provinces and the NCOP, and the reality that most important discussions and negotiations between the provinces and the national government regarding the division of revenue takes place in the Budget Council.<sup>147</sup>

### 4 3 2 Apportionment of revenue

The apportionment of revenue in the German Basic Law is done independently and separately from the allocation of the legislative competence on taxes. In terms of Article 106, detailed provision is made for the allocation of revenue from specific taxes solely to the *Bund*, the allocation of other revenue solely to the *Länder* and for the sharing of revenue from particular joint taxes. The limitation in the power of the *Länder* to legislate on taxes is in a way compensated for by providing the *Länder* with a constitutional guarantee to a substantial share of some federal taxes.<sup>148</sup>

Federal taxes in terms of Article 106 (1) include inter alia customs duties, capital transaction taxes and levies within the framework of the European Union. Examples of *Länder* taxes as found in Article 106 (2) are motor vehicle tax, inheritance tax and beer tax. In addition to these exclusive taxes that accrue to either the *Bund* or the *Länder* there are also some joint taxes that account for the biggest source of tax revenue in the country. These taxes are income tax (*Einkommensteuer*), corporate tax (*Körperschaftsteuer*) and turnover tax (*Umsatzsteuer*). Revenue from income tax and corporate tax are constitutionally allocated to the *Bund* and the *Länder* in equal shares, except for the fact that municipalities are also entitled to a share of these taxes,

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<sup>145</sup> Sec 76 (4) of the Constitution.

<sup>146</sup> *First Certification Case* paras 419 – 421.

<sup>147</sup> Wehner *Fiscal Federalism in South Africa* 73; Currie & De Waal *Constitutional and Administrative Law* 176 - 177.

<sup>148</sup> Currie *Constitution of Germany* 54.

which share has to be fixed by a federal law.<sup>149</sup> Currently the municipalities are entitled to 15% of the revenue from income tax, while the balance is divided equally between the *Bund* and the *Länder*. In view of the close link between income tax and the state of the economy, it is evident that the budgets of the *Bund* and the *Länder*, in particular as far as they depend on the revenue from income tax, are influenced by the growth in the economy. By providing for a meaningful percentage of the revenue from income tax to be allocated to the *Länder*, recognition is given to the link between income tax and the economic strength of a *Land*.<sup>150</sup> A substantial amount of income tax generated in particular *Länder* can thus flow back to it to be utilised by the respective *Länder* governments. Municipal taxes include property tax and local excise taxes, such as dog tax and entertainment tax.<sup>151</sup>

The division of revenue from turnover tax is the subject of a federal law that requires the consent of the *Bundesrat* and which forms part of the financial equalisation arrangements.<sup>152</sup> The Basic Law, however, lays down some requirements for the allocation of revenue from turnover tax. Such allocation must be based on the following principles, namely that the *Bund* and the *Länder* have an equal claim to funds from current revenue to finance their necessary requirements, and that such allocation shall be aimed at ensuring equal living conditions throughout Germany.<sup>153</sup> Since turnover tax is directly linked to economic growth, there is a built in incentive to promote the economy. Higher growth means more turnover tax and thus a larger source of revenue for both the *Bund* and the *Länder*.

The vertical division of revenue as described above is often referred to as the vertical financial equalisation (*vertikaler Finanzausgleich*) or primary financial equalisation (*primärer Finanzausgleich*).<sup>154</sup> The division of revenue amongst the *Länder*, which is in fact the most significant part of financial equalisation in Germany, is then referred

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<sup>149</sup> Art 106 (3), (4) and (5) of the Basic Law. See Bundesministerium der Finanzen *An ABC of Taxes* 52 - 53; Vogel *Grundzüge des Finanzrechts* 20; Klein *Bund und Länder nach der Finanzverfassung* 883.

<sup>150</sup> Von Münch *Grundgesetzkommmentar* 812.

<sup>151</sup> Art 106 (6) of the Basic Law. See Bundesministerium der Finanzen *An ABC of Taxes* 53.

<sup>152</sup> Art 106 (3), (4), and 107 of the Basic Law; Häde *Finanzausgleich* 211 et seq. Financial equalisation will be discussed in detail in **Ch 5**.

<sup>153</sup> Vogel *Grundzüge des Finanzrechts* 21.

<sup>154</sup> Vogel *Grundzüge des Finanzrechts* 21.

to as horizontal financial equalisation (*horizontaler Finanzausgleich*) or secondary financial equalisation (*sekundärer Finanzausgleich*).

The South African Constitution follows a different approach. While the Constitution makes provision for limited provincial and local government legislative authority over taxes, it compensates these two spheres of government to an extent by providing provinces, and local government, with a right to an equitable share of revenue collected nationally.<sup>155</sup> This means that all the major taxes, such as income tax, corporate tax, value-added tax and the fuel levy are in fact shared taxes since the proceeds of all these taxes are included in the national pool of funds that must be distributed equitably according to section 214 of the Constitution. Provinces can, through their participation in the NCOP, influence the legislation providing the equitable division of revenue since it has to follow the procedure according to section 76 (1) of the Constitution. The current practice, however, is that most of the discussions about the division of revenue takes place within the Budget Council, a statutory forum where the national Minister of Finance meets regularly with his provincial counterparts. This has the effect that the NCOP will not easily agree to major changes to the actual division of revenue.

Unlike the situation in Germany, South African provinces are not entitled to a specific percentage of the nationally collected revenue, but merely to an equitable share, which can lead to different percentage shares over time. There are quite a number of factors to be considered before a determination about the division of revenue can be made, for example, the national interest, the fiscal capacity of provinces and municipalities and the economic imbalances between and within provinces.<sup>156</sup> The equitable division of revenue is the main financial equalisation instrument used in South Africa.<sup>157</sup> In terms of section 214 (1) of the Constitution, there is a vertical division of revenue between the three spheres of government, and also a horizontal division of revenue that applies to the nine provinces. Such constitutional provision is to be expected in a decentralised system of government where there are various

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<sup>155</sup> Sec 214 (1) of the Constitution.

<sup>156</sup> Sec 214 (2) of the Constitution.

<sup>157</sup> Financial equalisation in South Africa will be discussed in detail in **Ch 6**.

inequalities between the different spheres of government as well as at regional, or even local, government level.

### 4 3 3 Borrowing

Proceeds from loans are in accountancy terms and in the context of company law not referred to as own capital, but regarded as an external source of funds.<sup>158</sup> Governments just like companies, ordinarily make use of borrowing as a way to supplement their own sources of revenue. Revenue from taxes forms the primary sources of funding for the state, while borrowing can be regarded as a secondary source of funds. In the context of public finance, borrowing is a significant and legitimate source of revenue that allows a government additional funds for longer-term expenditure responsibilities, in particular it creates more scope for capital projects. In order to get a complete picture of the constitutionally recognised sources of revenue for government, a discussion of the borrowing arrangements in both Germany and South Africa is included.

In the German Basic Law in Article 115 provision is made for the borrowing of funds that will lead to expenditure in future financial years, with the requirement that federal legislation must authorise it and provide the necessary details about the loan. A further condition contained in this section is that the revenue from borrowing may not exceed the amount available for investment as provided for in the budget. Borrowing relates to the macro-economic situation in the whole country, hence the requirement for federal legislation to provide further details. Article 109 (1) stipulates that the Federation and the *Länder* shall be autonomous and mutually independent in their budget management. It is, however, evident that the common duty of the *Bund* and the *Länder* in Article 109 (2) to take the requirements of macro-economic equilibrium into account, binds them together economically speaking and supports the fact that federal legislation is necessary to authorise the borrowing of funds and the assumption of guarantees. These arrangements place the management of public finance firmly within the constitutional context. This nexus is further strengthened by the fact that

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<sup>158</sup> Cilliers et al *Korporatiewe Reg* (1992) 193.

the responsibility for economic stability and well being of the community can be linked to one of the fundamental principles in the Basic Law, namely the social state principle.<sup>159</sup>

In South Africa borrowing arrangements for all three spheres of government are constitutionalised as they are in Germany. During the process of negotiations that led to the adoption of the current Constitution, the Financial and Fiscal Commission argued that the financial intergovernmental relations system should be structured in such a way that provinces have reasonable access to sources of funding in addition to their share of revenue from taxes.<sup>160</sup> Long-term infrastructure projects by provinces require loan financing that can be incurred by provinces and structured over the same period as the project for which the capital is required. In this way, the cost of long-term capital projects can be spread over time. The same argument would apply to the borrowing arrangements for local government.

The result of the constitutional negotiations was the inclusion of a number of provisions relating to borrowing arrangements. The basic legal requirements for budgets for all three spheres of government are contained in section 215 (3) of the Constitution. These inter alia require that budgets must indicate clearly any intended borrowing and other forms of public liability that will increase public debt. Furthermore, government guarantees may only be given in accordance with conditions stipulated in national legislation.<sup>161</sup> Specific provision is made in the Constitution for provincial and municipal loans. Section 230 and 230A stipulate that provinces and municipalities may, in accordance with national legislation, raise loans for capital or current expenditure.<sup>162</sup> Loans for current expenditure may only be raised when necessary for bridging purposes within a fiscal year.

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<sup>159</sup> Art 20 (1) of the Basic Law.

<sup>160</sup> FFC *Framework for Intergovernmental Fiscal Relations* 8.

<sup>161</sup> Sec 218 of the Constitution.

<sup>162</sup> Sec 230, which originally made provision for provincial and municipal loans, was amended in 2001 to have two separate but similar provisions, namely sec 230 (provincial loans) and 230A (municipal loans). See Constitution of the RSA Amendment Act, 34 of 2001, and Constitution of the RSA Second Amendment Act, 61 of 2001.

In addition to this basic framework for loans and guarantees found in the Constitution, there is national legislation that deals with the matter in more detail. The Borrowing Powers of Provincial Governments Act, 48 of 1996, provides certain conditions to the right of provinces to raise loans.<sup>163</sup> This Act has to date never been used to obtain loans for provinces. The Public Finance Management Act, 1 of 1999, contains more comprehensive provisions regarding loans, guarantees and other financial commitments by national and provincial governments as well as government institutions referred to in this Act. Both these Acts are aimed at the promotion of efficient financial management and accountable government in accordance with the Constitution. In view of the existence of the Loan Co-ordinating Committee, created by the Borrowing Powers of Provincial Governments Act, 1996, and the strong views of the Minister of Finance in this respect, the *de facto* position currently is that provinces are not allowed to obtain long-term loans. Bridging finance, such as overdraft arrangements with banks, does however take place. Loans for capital expenditure such as building and maintenance of roads, schools and clinics could enhance economic growth and it is hoped that there will be a change in the *de facto* situation in order to open new sources of funding to provinces. New comprehensive financial management legislation for local government, covering issues such as management of financial affairs of municipalities and borrowing, was adopted by Parliament during the second half of 2003.<sup>164</sup>

#### **4 3 4 Interim conclusion**

In Germany a distinction is made between the legislative authority to raise taxes and the allocation of the revenue received from taxes. The Basic Law provides for exclusive federal, exclusive *Länder* and concurrent legislative authority on taxes (Article 105) and in a separate provision determines the allocation of revenue from taxes (Article 106), providing exclusive tax revenue to the *Bund* as well as exclusive tax revenue to the *Länder*. The major taxes, such as income tax, corporate tax and

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<sup>163</sup> See Wehner *Fiscal decentralization in South Africa: an initial comment on provincial budgetary performance* Unpublished paper presented at the 19<sup>th</sup> IPSA World Congress in Durban, South Africa (4 July 2003) 3.

<sup>164</sup> The Municipal Finance Management Act, 56 of 2003.

value-added tax are shared taxes. The fact that there is a distinct provision for exclusive legislative authority and exclusive revenue to both levels of government does not detract from the importance of the shared taxes that require a great deal of co-operation between the *Bund* and the *Länder* in the legislative and actual distribution processes. In this respect, the *Länder* have a strong voice in the federal legislative process through their participation in the *Bundesrat*, a role that is constitutionally guaranteed in terms of Article 79 (3) of the Basic Law.

These constitutional arrangements in the Basic Law create a balanced approach in terms of which the distinct roles of the *Bund* and the *Länder* are stipulated, but the dominant feature is that there must be co-operation between the two levels of government. The principle of *Bundestreue* is fundamental to the effective functioning of the federal system, in particular with respect to financial intergovernmental relations.<sup>165</sup> The particular design and functioning of the 'financial constitution' is essentially an exercise of co-operative federalism or co-operative government, as it is referred to in the South African Constitution.<sup>166</sup> The interaction between the *Bund* and the *Länder* in the development of federal tax laws and the division of revenue from federal taxes can only effectively take place in a co-operative spirit.

In South Africa the constitutional arrangements follow a somewhat different approach, namely that exclusive legislative authority over the major taxes is allocated to the national government, while provinces' legislative authority on taxes is fairly limited and subject to national regulation. The South African provinces have a potentially important role to play in the National Council of Provinces, but they are in a weaker position than the German *Länder* as far as national legislation on taxes is concerned.

An essential characteristic of the South African constitutional system is the principles of co-operative government contained in Chapter 3 of the Constitution. Simeon

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<sup>165</sup> Von Münch *Staatsrecht* 237, 240. See also discussion of *Bundestreue* under 2 3.

<sup>166</sup> Lerche *Principles of German Federalism* in Kirchhof & Kommers (eds) *Germany and its Basic Law* (1993) 71 81; Chapter 3 (Co-operative Government) of the Constitution.

described the South African constitutional system as shared federalism, while specifically referring to the fiscal arrangements where the focus is also on "shared, concurrent governance".<sup>167</sup> The principles of co-operative government play an overarching role in the functioning of government in South Africa, similar to the position in Germany, and are thus important in the field of taxes and allocation of revenue.

#### **4 4 Conclusion**

This Chapter provides a comparison of the constitutional arrangements pertaining to the division of powers and obligations and the allocation of financial resources in Germany and South Africa. The comparison, although focused on the text of the Basic Law and the South African Constitution respectively, also includes references to historical and economic factors in both countries in an attempt to create a better understanding of the current constitutional position.

Different approaches were used in the design of the German Basic Law and the South African Constitution, in particular as far as they relate to the division of powers between the various levels or spheres of government. An important difference in design, for example, is the long list of exclusive federal legislative powers in the Basic Law, while in the case of South Africa these powers are not listed and are residual powers of the national government. In both constitutional systems, much use is made of concurrency, while the Basic Law creates a pre-emptive power to federal legislation in the concurrent field.<sup>168</sup> The Constitution on the other hand does not use this approach, but provides extensive arrangements to deal with conflict between national and provincial legislation in the concurrent field.<sup>169</sup> This reflects a different basic philosophy in South Africa compared to the German Basic Law, namely that both spheres of government continue to have full jurisdiction in the concurrent

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<sup>167</sup> Simeon 1998 (13) *SAPR/PL* 68.

<sup>168</sup> Art 72 of the Basic Law. See Currie *Constitution of Germany* 49; Von Münch *Staatsrecht* 214 - 215; Von Münch *Grundgesetzkommentar* 24 - 30.

<sup>169</sup> Sec 146 - 150 of the Constitution.



field.<sup>170</sup> In both countries, the national government has utilized its legislative authority in the concurrent field extensively leaving little scope for concurrent legislation by the *Länder* and provinces respectively.

In reviewing the provisions in the 'financial constitution' in both Germany and South Africa, there are also a number of apparent differences, such as the right of the *Länder* to influence federal tax legislation. In fact, the *Länder* through their participation in the *Bundesrat* have an equal say to the *Bund* in the adoption of federal tax legislation which in practice accounts for the major sources of tax revenue in Germany. In addition, the consent of the *Bundesrat* is also required for federal legislation pertaining to financial equalisation (*Finanzausgleich*).<sup>171</sup> These constitutional arrangements obviously strengthen the fiscal autonomy of the *Länder*. Herzog commented that the 'political independence' of the *Länder* is due to their strong position in the *Bundesrat*.<sup>172</sup>

The provinces in South Africa are not in a similarly strong position. A national Bill that imposes taxes is regarded as a money Bill and does not require the consent of the National Council of Provinces.<sup>173</sup> The financial equalisation legislation, that is the Act that provides for an equitable division of revenue, however, requires the approval of the National Council of Provinces.<sup>174</sup> In this case provinces can thus influence the actual division of revenue law, although in reality the Budget Council is where most of the intergovernmental discussions regarding the division of revenue takes place. The dominance of the ANC in South African politics currently limits the possibility of the NCOP playing a stronger role. Constitutional provisions contribute to the development of a province's fiscal autonomy. When the two systems (the German system and the South African system) are compared, one concludes that the provinces in South Africa do not enjoy the same degree of autonomy as the *Länder* in Germany.

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<sup>170</sup> Haysom *Federal Features of the Final Constitution* in Andrews & Ellmann *The Post-Apartheid Constitutions* (2001) 504-508.

<sup>171</sup> Art 106 (3) and 107 of the Basic Law.

<sup>172</sup> Herzog *Separation and Concentration of Power* 395.

<sup>173</sup> Sec 77 read with sec 75 of the Constitution. See *First Certification Case* para 416.

<sup>174</sup> Sec 76 (4) (b) of the Constitution. See *First Certification Case* paras 419 - 421.

Co-operative government is essential to the functioning of financial intergovernmental relations in South Africa. The Intergovernmental Fiscal Relations Act, 97 of 1997, gives expression to the spirit of co-operative government in the area of intergovernmental fiscal relations, inter alia through the establishment of the Budget Council and the Budget Forum.<sup>175</sup> Wehner is probably correct in stating that the Budget Council has become the most powerful institution for intergovernmental fiscal decisions, but it should be added that the Extended Cabinet, which includes the nine Premiers and Members of the Executive Councils responsible for Finances, is the highest co-operative mechanism for finalizing the division of revenue.<sup>176</sup> The process of debating the actual division of revenue between the spheres of government resulted in the annual Division of Revenue Act and is a clear example of co-operative government.

In both Germany and South Africa the focus of legislative activities, including the legislative authority over the main taxes, is at the federal or national level of government while most of the administration or implementation of national legislation is done by the *Länder* and provinces respectively.<sup>177</sup> Vertical fiscal imbalances due to particular constitutional arrangements regarding taxes exist in both countries and this creates a need for some form of financial equalization arrangements. Given the fact that South Africa has huge horizontal or inter-provincial imbalances in income distribution, the Constitution had to provide for a revenue sharing model for the redistribution of the nationally collected revenue. While the emphasis in South Africa is on redistribution of revenue to address historical inequalities, to alleviate poverty and thus to improve the overall quality of life of all the people, the focus in Germany is to provide equal living conditions throughout the country as stipulated in the Basic Law.<sup>178</sup> The *Intergovernmental Fiscal Review 2003* makes it clear that the focus in South Africa is on the improved delivery of services “to ensure the progressive

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<sup>175</sup> The Budget Council is a consultative forum consisting of the Minister of Finance and his or her nine provincial counterparts, while the Budget Forum also includes representatives of local government.

<sup>176</sup> Wehner *Fiscal decentralization in South Africa* 12; National Treasury *Intergovernmental Fiscal Review 2003* 6.

<sup>177</sup> National Treasury *Intergovernmental Fiscal Review 2003* 5; Schultze 2003 (Vol 3 nr 3) *Federations* 13.

<sup>178</sup> Art 106 (3) of the Basic Law.

realization of improved quality of life for all South Africans.”<sup>179</sup> These socio-economic aims in both countries are aims that can only be effectively addressed in a spirit of co-operative government.

The development of intergovernmental fiscal relations in South Africa is still in its childhood and South Africa can learn from the development of the German system as they also faced huge developmental challenges in their early years. After only a few years, the various institutional elements and practical mechanisms have been established in and between the various levels of government in South Africa. The *Intergovernmental Fiscal Review 2000* states that there is a systematic unfolding of a set of intergovernmental fiscal relations in South Africa characterized by co-operative governance.<sup>180</sup> There was a distinct move towards fiscal decentralization in many countries during the past few decades, and South Africa’s developments since 1994 is in line with these global trends.<sup>181</sup> In this unfolding process towards decentralization, one of the challenges facing South Africa is how to balance the competing notions of provincial fiscal autonomy and national unity. The challenge is to find the right balance between fiscal centralization and decentralization within the political and socio-economic context in South Africa.

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<sup>179</sup> National Treasury *Intergovernmental Fiscal Review 2003* 14.

<sup>180</sup> National Treasury *Intergovernmental Fiscal Review 2000* 10.

<sup>181</sup> Wehner *South Africa’s provinces and intergovernmental fiscal relations: A review of some key developments in the period 1997/98 to 2002/03 and issues to be resolved in the years ahead* (1 November 2002) 1.

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## Chapter 5 Financial equalisation in Germany

### 5 1 Introduction

One of the fundamental principles of the German constitutional system, which is stated clearly in Article 20 (1) of the Basic Law, is that it is a federal state. This implies inter alia that there is a constitutional division of powers and functions between the *Bund* and the *Länder*. The financial constitution or *Finanzverfassung*, is a crucial element of this federal system since it sets the foundation for realising the constitutional obligations of both the *Bund* and the *Länder*. A significant part of the financial constitution is the provisions in the Basic Law that concern the allocation of financial resources to the *Bund* and the *Länder*. This was discussed in **Chapter 4**. The various constituent units within the federal state have, in view of their interwoven financial relations, a common constraint, namely, that they must take account of the limited tax capacity of the whole economy in their financial interaction.<sup>1</sup> There are only limited financial resources that can be claimed by both the *Bund* and the *Länder*. Their budgetary and financial planning must be aimed at managing the limited financial resources in such a manner that both can fulfil their constitutional mandates effectively and so benefit the country. The problem is that taxes are assigned unevenly to the two levels of government. If the *Länder* have more constitutionally allocated functions than they have financial resources, while the *Bund* has excess

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<sup>1</sup> Fischer-Menshausen in Von Münch (hrsg) *Grundgesetzkommentar* Band 3 (1996) 874.

financial resources available to fund its obligations, there is a financial imbalance. This is referred to in economic terms as a vertical fiscal gap and is common in multi-level systems of government.<sup>2</sup> This problem is compounded by the fact that there are economic disparities and differences in financial capacity between the various *Länder*. Some *Länder* cannot fulfil their constitutional obligations fully while others have no such problem. This is referred to as a horizontal fiscal gap. In **Chapter 4** brief reference was made to the constitutional accommodation of addressing these financial imbalances by way of financial equalisation (*Finanzausgleich*).

Financial equalisation is fundamental to the functioning of the constitutional systems of both Germany and South Africa. The purpose of this chapter is to provide a detailed description of the purpose and functioning of financial equalisation in Germany. This analysis will include a discussion on the effect the unification of Germany had, and still has, on financial equalisation. Current problems with the application of the constitutional provisions will be highlighted with a view to ascertain what lessons can be learnt from them. This analysis is done in order to compare the situation in South Africa to that in Germany. A detailed analysis will follow in **Chapter 6**.

## **5 2 Economic situation in post-War Germany**

Economic considerations can, and often do, play a role in designing the financial intergovernmental relations in a decentralised or federal system of government. This appears to be the case in Germany immediately after World War II when the new constitutional model was developed, and the process of rebuilding the country was started.

When World War II ended in 1945 Germany and large parts of Europe were left in ruins. Infrastructure such as roads, bridges and dams were damaged and thousands of buildings in towns throughout Germany were partly or completely destroyed. Agriculture was severely hampered through a lack of fertilizer and seed and many farmlands that became battlefields still had unexploded bombs. The economy was

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<sup>2</sup> Ajam *The evolution of devolution: fiscal decentralisation in South Africa* in Abedian & Biggs

wrecked, normal trade almost came to a standstill and the people were very poor and had to find whatever food they could.<sup>3</sup> There was a massive need for the reconstruction of the German economy. In addition to the economic and social issues related to rebuilding the German economy, there were also important constitutional and political questions that had to be addressed. This included the development of a new constitutional system for Germany.

It was not only Germany that was in ruins; the rest of Europe was also in a state of devastation and in need of huge economic reconstruction. Many European nations were in serious economic trouble and could not address their immediate needs on their own. In 1947 a conference of 16 nations that took place in Paris, France, focussed on the economic needs of Europe. As a result of this, the Organisation for European Economic Cooperation was formed.<sup>4</sup> Although Germany's situation was unique in the sense that it was under the control of the Allied Occupation Forces and the Soviet Union, the economic situation in Germany should not be seen in isolation as it was part of Western Europe and the recovery of the German economy was therefore part of the economic recovery of Europe.

The United States of America responded to the dire needs in Europe, particularly in Germany, by the adoption of the Marshall Plan. This was a massive assistance plan for the recovery of Europe in cooperation with sixteen European nations.<sup>5</sup> The establishment of the Organisation for European Economic Cooperation was a positive response to the American initiative. Thus both sides of the Atlantic became involved in the long-term project of cooperation for the European economic recovery.<sup>6</sup> Soon it became clear that the improvement of economic conditions in Western Europe was dependent on the economic recovery of Germany and specific attention was given, in terms of the Marshall Plan, to assist in the rebuilding of the German economy. When

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*Economic globalization and fiscal policy* (1998) 54 57.

<sup>3</sup> Mayer *German Recovery and the Marshall Plan 1948 – 1952* (1969) 7.

<sup>4</sup> Mayer *German Recovery* 19. The 16 nations that attended the conference and formed the OEEC were Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey and the United Kingdom. Germany was not represented at the conference but became a member later. The establishment of the OEEC paved the way for economic integration in Europe that followed in the second half of the 20<sup>th</sup> century.

<sup>5</sup> Mayer *German Recovery* 9. In June 1947 the US Secretary of State, George C Marshall, proposed this assistance plan for the reconstruction of Europe.

<sup>6</sup> Mayer *German Recovery* 18 – 21; 102 - 105.

the Federal Republic of Germany was established in 1949, a special cabinet minister was appointed for the administration of the Marshall Plan and Germany became a full member of the Organisation for European Economic Cooperation. The implementation of the Marshall Plan in Europe, more specifically in Germany, contributed significantly to what became known as the German *Wirtschaftswunder* (economic miracle), that was achieved with the active cooperation of the German people and their new political leaders, including Chancellor Konrad Adenauer and Professor Ludwig Erhard.<sup>7</sup>

It was Erhard's vision that prosperity for all must be achieved through competition.<sup>8</sup> Democracy and a free economy had to be restored in order to support the recovery of Germany. The economic policy followed by the new government of the Federal Republic of Germany, established in 1949, was a social market economic policy that was clearly linked to Erhard's vision of prosperity for all. In a relatively short period of time, this economic policy made a significant contribution to the reconstruction of Germany. This recovery can be seen in the dramatic increase in gross domestic income from 1949 (DM 47,1 milliard) to 1956 (DM 85,8 milliard).<sup>9</sup> The economic policy had to be in line with the new constitutional framework provided by the Basic Law. It is evident that a social market economy suits the fundamental principles of a democratic and social federal state as outlined in Article 20 of the Basic Law. In particular, the social state principle requires positive action from the state to promote public well-being.<sup>10</sup>

### **5 3 Purpose of financial equalisation**

In order to have a clear understanding of the purpose of financial equalisation, as it is acknowledged and implemented currently in Germany, a brief overview of the

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<sup>7</sup> Mayer *German Recovery* 99. Konrad Adenauer became the first Chancellor of the FRG and Ludwig Erhard, an economics professor who played a key role in the economic recovery of the American and British occupied zones, was appointed Vice-Chancellor and Minister of Economic Affairs.

<sup>8</sup> Erhard *Prosperity through competition* (1958) 2 – 3.

<sup>9</sup> Erhard *Prosperity through competition* 3, 8.

<sup>10</sup> Currie *The Constitution of the Federal Republic of Germany* (1994) 20 – 24.

historical development of financial constitutional arrangements since 1949, is provided.

The design of the original financial constitution for Germany in 1949 was strongly influenced by the Western occupation forces and favoured a clear division of competences between the *Bund* and the *Länder*. This created various centres of authority in the country and therefore a divided model of federalism. One of the aims of the Western occupation forces was to financially weaken the *Bund*, a view that was clearly influenced by the horrific consequences of the preceding years of authoritarian national-socialist rule.<sup>11</sup> The legislative authority for taxes was, however, still concentrated at the federal level. Despite various rounds of negotiations between the Parliamentary Council and the military governors in the Western occupied territory, they could not agree on all the provisions relating to the division of financial resources.<sup>12</sup> As a result it was decided that only provisional arrangements would be made for financial intergovernmental relations in the Basic Law. This created scope for later finalisation by the Federal Parliament. A law, that contained financial constitutional arrangements, was adopted in 1955, and these provisions formed the legal basis for financial equalisation until 1969.<sup>13</sup>

Major financial reform took place in 1969 as a result of the work of the *Troeger-Kommission* of investigation.<sup>14</sup> These reform measures changed the character of the federal system from a divided model to a co-operative model, inter alia by constitutionally accommodating the already common forms of co-operation between the *Bund* and the *Länder*. The constitutional division of functions between the *Bund* and the *Länder* was amended to make provision for the cooperation on joint functions. A major change to the tax arrangements was made to extend the scope of joint taxes so that both the *Bund* and the *Länder* would share the revenue raised from income tax, corporate tax and turnover tax.<sup>15</sup> Some of the amendments to the Basic Law in 1969

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<sup>11</sup> Klein *Bund und Länder nach der Finanzverfassung des Grundgesetzes* in Benda *Handbuch des Verfassungsrechts* (1983) 863 864.

<sup>12</sup> Wieland "Die verfassungsrechtliche Rahmenordnung des Finanzausgleichs" *Jura* 1988 (8) 410 411; Fischer-Menshausen in Von Münch *GG Komm* 876; Klein *Bund und Länder nach der Finanzverfassung* 865.

<sup>13</sup> *Finanzverfassungsgesetz* of 23 December 1955.

<sup>14</sup> Laufer & Münch *Das föderative System der Bundesrepublik Deutschland* (1997) 158; Fischer-Menshausen in Von Münch *GG Komm* 876; Klein *Bund und Länder nach der Finanzverfassung* 865.

<sup>15</sup> Art 106 of the Basic Law.



were the inclusion of Article 91a and 91b, on joint responsibilities between the *Bund* and the *Länder*, Article 104a, on the apportionment of expenditure between the *Bund* and the *Länder* and Article 105 (2a) that regulated the power of the *Länder* to legislate on local excise taxes. These amendments all supported the notion of co-operative federalism.

The last major financial reform took place after the unification of Germany in 1990. The new *Länder* in the former *Deutschen Demokratische Republik (DDR)* constituted approximately 25% of the population of the Federal Republic of Germany while its estimated economic output was about 10%.<sup>16</sup> Low wages, low productivity, a distorted structure of prices, wages and subsidies, a very limited range of products and high foreign debts were characteristic of the economic situation in the new *Länder*. These issues had to be addressed in order to achieve successful economic integration and were linked to the political integration of the new *Länder* with the old *Länder*.

In a united Germany, the new *Länder* had to change from a centrally planned economy to a market economy where the free play of market forces existed within an institutional framework that provided social security. In other words, a social market economy.<sup>17</sup> The new *Länder* also had to be brought into the existing financial intergovernmental system.<sup>18</sup> This could not be done immediately as special arrangements that supported the rebuilding of the new *Länder* and their eventual participation in the financial equalisation process, had to be made. As the new *Länder* were initially excluded from participation in the financial equalisation process, a substitute arrangement was made with the establishment of a special fund, namely the *Fonds Deutsche Einheit* (German Unity Fund) to which both the *Bund* and old *Länder* in the West contributed.<sup>19</sup> Special measures were adopted to address the critical needs of the new *Länder*, for example, covering their huge budget deficits, providing support for the transformation to a market economy and the rebuilding of

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<sup>16</sup> Lipshitz & McDonald *German Unification – economic issues* (1990) 3.

<sup>17</sup> Lipshitz & McDonald *German Unification* 5, 166.

<sup>18</sup> The *Vertrag über die Schaffung einer Währungs-, Wirtschafts- und Sozialunion* (Unification Treaty) of 18 May 1990 laid the foundation for the integration of the new *Länder* into the existing economy and structures of the Federal Republic of Germany.

<sup>19</sup> Fischer-Menshausen in Von Münch *GG Komm* 884.

infrastructure.<sup>20</sup> Since 1 January 1995 new arrangements were implemented, in terms of which the new *Länder* participated fully in the operation of the financial constitution, this included participating in the financial equalisation process.<sup>21</sup> The effect of unification on the financial equalisation process will be discussed in 5.5.

One of the fundamental principles of the German constitutional system is the federal principle (*Bundesstaatsprinzip*) contained in Article 20 (1)<sup>22</sup> of the Basic Law, and constitutionally entrenched in Article 79 (3).<sup>23</sup> This principle describes the constitutional system and acknowledges the existence of a number of constituent units and the inequality between them, that in practice leads to differences in the level of economic activity and living standards in the various constituent units.<sup>24</sup> The practical reality of economic disparities and differences in financial capacity between the *Länder* amongst themselves and between the *Länder* and the *Bund*, warrants special arrangements to distribute the available financial resources in such a way that both levels of government can perform their constitutionally allocated functions properly.

In terms of the federal principle, a degree of autonomy of the individual constituent units is recognised. Within the German constitutional system, the federal principle requires searching for a balance between the autonomy of the *Länder* and the solidarity within the state. The principle of *Bundestreue* is applicable in this and implies that both the *Bund* and the *Länder*, recognising each other's constitutional roles, have a duty to assist one another.<sup>25</sup>

The purpose of financial equalisation is firstly to create a balance in the finances of the *Bund* and the *Länder* in relation to each other, and amongst the individual

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<sup>20</sup> Fischer-Menshausen in Von Münch *GG Komm* 883.

<sup>21</sup> Renssch "Neuregelung der Bund/Länder-Finanzbeziehungen: Volle Einbeziehung der neuen Länder ab 1995" *Gegenwartskunde* 1/1994 75 77.

<sup>22</sup> Sachs *Grundgesetz Kommentar* (1996) 630 et seq; Currie *The Constitution of the Federal Republic of Germany* (1994) 18; Von Münch *Staatsrecht Band I* (1993) 196. See also discussion of fundamental constitutional principles under 2.1.2.

<sup>23</sup> Art 79 (3): "Amendments to this Basic Law affecting the division of the Federation into Länder, their participation in the legislative process, or the principles laid down in Articles 1 and 20 shall be prohibited."

<sup>24</sup> Häde *Finanzausgleich* (1996) 256.

<sup>25</sup> Häde *Finanzausgleich* 257.

*Länder*.<sup>26</sup> In an important judgement by the *Bundesverfassungsgericht* in 1986, the Court stated that the purpose of financial equalisation is to put the *Bund* and the *Länder* in a financial position that allows them to perform their constitutionally allocated duties, and to enable them to develop their respective autonomies and own responsibilities regarding constitutional obligations.<sup>27</sup> Financial equalisation in Germany consists of three elements, namely vertical equalisation (*vertikalen Finanzausgleich*), horizontal equalisation (*horizontalen Finanzausgleich*) and additional grants from the *Bund* to individual *Länder* (*Bundesergänzungszuweisungen*). Each of these contributes to the overall aim of balancing the financial resources of both levels of government. The *Bund* and the *Länder* are equal partners in terms of the federal financial equalisation process. They both have a constitutionally guaranteed claim to the financial resources available to fund the functions assigned to them. Article 106 (3) states explicitly that "the Federation and the *Länder* shall have an equal claim to funds from current revenue to finance their necessary expenditure." The financial equalisation process is therefore aimed at creating an equilibrium position where neither of the two levels of government is required to financially carry the responsibilities of the other.<sup>28</sup>

The individual *Länder* are responsible for fulfilling their own constitutional duties with the financial resources available to them. However there are differences in financial needs and differences in financial capacity between the *Länder*. This is a common characteristic in a federal state. The purpose of horizontal financial equalisation is to create a position of "reasonable equalisation" of the financial disparity between the various *Länder*, taking into account the differences in financial capacity of the municipalities (*Gemeinden*) within each *Land*. The provision in Article 107 (2) of the Basic Law that bases the horizontal financial equalisation on financial need of the various *Länder*, firmly links financial equalisation to the principle of federal solidarity, therefore means that, being part of a federal state, the

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<sup>26</sup> Fischer-Menshausen in Von Münch *GG Komm* 981.

<sup>27</sup> A judgement of the *Bundesverfassungsgericht* delivered on 24 June 1986 - *BVerfGE* 72, 330 383. See discussion under 7 3 2; also Mußnug "Der horizontale Finanzausgleich auf dem Prüfstand des Bundesverfassungsgerichts - *BVerfG*, *NJW* 1986, 2629" *JuS* 1986 (11) 872; Wieland "Rahmenordnung des Finanzausgleichs" 419.

<sup>28</sup> Häde *Finanzausgleich* 223; Fischer-Menshausen in Von Münch *GG Komm* 981.

*Länder* are mutually bound to support each other.<sup>29</sup> In one of its early judgements the *Bundesverfassungsgericht* stated that the federal solidarity principle implies that there is a duty on the financially strong *Länder* to support the financially weak *Länder* within pre-determined limits.<sup>30</sup> The Court further said that the federal solidarity principle would be violated if the financial equalisation leads to a situation of absolute equality (*Nivellierung*) of the finances of the *Länder*. This implies that there are limits to the application of the federal solidarity principle. Article 109 (1) of the Basic Law states clearly that the *Bund* and the *Länder* are mutually independent and autonomous for their budget management. The duty of the *Länder* to assist one another places a constraint on their financial autonomy, but does not nullify it. Financial equalisation must therefore be implemented in such a way that a balance is found between the duty to assist one another and the prohibition against absolute equality by acknowledging the constitutional stipulated financial autonomy of the *Länder*.<sup>31</sup>

In terms of Article 106 (3) of the Basic Law a fair balance must be established in co-ordinating the financial requirements of both the *Bund* and the *Länder* taking into account the requirement to ensure equal living conditions throughout the country. In analysing the wording of Article 107 (2) of the Basic Law, it is apparent that the development of equal living conditions throughout the country is included in the aim of a reasonable equalisation of financial disparities. There is no general constitutional duty on the *Länder* to ensure an absolute equality of living conditions; the aim is merely to develop equal living conditions within the parameters of reasonable equalisation.<sup>32</sup> In view of the recognition of financial autonomy of the *Länder* and the use of the term "reasonable equalisation", the provision of financial support to the weaker *Länder* through financial equalisation may not have the result of an absolute equality of *Länder* finances. Every financial equalisation arrangement is thus a

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<sup>29</sup> Arndt *Finanzausgleich und Verfassungsrecht* (1997) 4; Fischer-Menshausen in Von Münch *GG Komm* 1027.

<sup>30</sup> A judgement of the First Senate of the *Bundesverfassungsgericht* delivered on 20 February 1952 - *BVerfGE* 1, 117 131. See discussion under **7 3 1**.

<sup>31</sup> Arndt *Finanzausgleich* 5; Maunz - Dürig *Grundgesetzkommentar Band IV* (1991) 107 7.

<sup>32</sup> Arndt *Finanzausgleich* 17.

compromise between the social responsibility of the *Länder* on the one hand and their claim to financial autonomy on the other.<sup>33</sup>

#### **5 4 The financial equalisation process**

The various steps in the financial equalisation process are placed in a particular order for good reason. The first step is the vertical equalisation that is aimed at providing sufficient finances to the overall needs of both the *Bund* and the *Länder*. Both levels of government have, in terms of Article 106 (3) of the Basic Law, an equal claim to funding their constitutionally allocated functions. When the vertical equalisation is completed, the next step is to focus on the horizontal financial equalisation, that is, the financial equalisation between the individual *Länder*. In terms of Article 107 (2) of the Basic Law, it must be ensured through federal legislation that there is a reasonable equalisation of financial disparities between the individual *Länder*. This provision envisages the horizontal transfer of funds from one *Land* to another within the framework of *Länder* equalisation. The last step in the order of events is the possibility of additional grants by the *Bund* to financially weak *Länder* to supplement their general financial needs.<sup>34</sup> These three steps in the financial equalisation process are designed to follow in a logical order by first looking at the overall balance in finances, then at the equilibrium at the *Länder* level and lastly to provide additional assistance to individual *Länder* needs.

The financial equalisation process is, however, not a mere mechanical exercise dealing with the division of funds, but includes important political and social issues such as the aim to provide equal living conditions and proper budgeting and financial management in the *Länder*. The process also addresses the question of what a reasonable equalisation of financial disparities is.

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<sup>33</sup> Fischer-Menshausen in Von Münch *GG Komm* 1028.

<sup>34</sup> Art 107 (2) of the Basic Law; Häde *Finanzausgleich* 223.

#### 5 4 1 Vertical financial equalisation

This part of the financial equalisation process is relatively uncomplicated as it is set out clearly in the Basic Law. Article 106 (3) of the Basic Law stipulates that the revenue from the three major taxes, namely income tax, corporate tax and turnover tax shall accrue jointly to the *Bund* and the *Länder*, except for that part of the income tax that will be allocated to the municipalities in terms of Article 106 (5). The municipal share of income tax is transferred by each *Land* to their municipalities. The revenue from income tax and corporate tax is shared by the *Bund* and the *Länder* and is constitutionally guaranteed as such. The division of the revenue from turnover tax is not fixed since it must be determined by federal legislation, and this requires the consent of the *Bundesrat*.<sup>35</sup>

The following division of revenue from income tax and corporate tax, was adopted as part of the financial reform of 1969, and still reflects the position:<sup>36</sup>

Income tax:	Municipalities	15%
	<i>Bund</i>	42, 5%
	<i>Länder</i>	42. 5%
Corporate tax	<i>Bund</i>	50%
	<i>Länder</i>	50%

The municipalities (*Gemeinden*) form constitutionally part of the *Länder* and are treated as such in the financial equalisation process. Specific reference is, however, made to the municipalities in Articles 106 and 107 of the Basic Law, for example, in relation to their share of income tax in Article 106 (3) and (5). The *Länder* are responsible for the finances of the municipalities located within their respective geographical areas of jurisdiction, while the municipalities are responsible for managing the affairs of the local communities as regulated by provincial law.<sup>37</sup> The

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<sup>35</sup> Art 106 (3) and 107 of the Basic Law; Fischer-Menshausen in Von Münch *GG Komm* 991; Isensee & Kirchhof *Handbuch des Staatsrechts* Band IV (1990) 20.

<sup>36</sup> *Gemeindereformgesetz* of 8 September 1969; Fischer-Menshausen in Von Münch *GG Komm* 991; Mußnug 1986 (11) *JuS* 872.

<sup>37</sup> Art 28 (2) of the Basic Law; Isensee & Kirchhof *Handbuch des Staatsrechts* 1062.

financial needs of the municipalities are thus included as part of the financial needs of each *Land* and must be taken into account in the financial equalisation process.<sup>38</sup> Article 107 (2) of the Basic Law stipulates that the financial capacity and requirements of the municipalities and associations of municipalities, must be considered in the horizontal financial equalisation process.

The municipal share of income tax must be paid over to the various *Länder*, which is then responsible for distributing that revenue to the individual municipalities on the basis of income tax paid by their population. The subsequent distribution of those funds is regulated by the *Gemeindefinanzreformgesetz* (Municipal Financial Reform Act) of 1969.<sup>39</sup>

The fact that the division of turnover tax between the *Bund* and the *Länder* is not constitutionally fixed, as is the case with the income tax and corporate tax, creates some flexibility in the financial equalisation process. While there are fixed percentages of revenue from income tax and corporate tax allocated to the *Bund* and the *Länder*, the percentage shares of the revenue from turnover tax varies over time since it is the subject of federal legislation. The flexibility of this provision is necessary to accommodate changes in the financial demands of the *Bund* and the *Länder*. The division of turnover tax is the crux of the vertical financial equalisation since it determines the eventual financial position of the *Bund* and the *Länder*.<sup>40</sup>

In view of the fact that the *Bundesrat* must give its consent to the federal law determining the actual division of turnover tax, the *Länder*, through their participation in the *Bundesrat*, are in a strong position to influence the distribution of these funds. It can therefore be expected that tough negotiations take place about the Federal Government's Bill regarding this financial equalisation. A few guiding principles are given to the Federal Parliament to consider in the process of developing and adopting this law, namely:

- ❖ The recognition of equal claims of the *Bund* and the *Länder* to the funds from current revenue to finance their necessary expenditure;

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<sup>38</sup> Art 106 (9) of the Basic Law.

<sup>39</sup> Art 106 (5) of the Basic Law; Isensee & Kirchhof *Handbuch des Staatsrechts* 1063.

<sup>40</sup> Fischer-Menshausen in Von Münch *GG Komm* 993.

- ❖ The determination of the necessary expenditure of both levels of government on the basis of multi-year financial planning;
- ❖ The need for a fair balance in the consideration of the financial requirements of the *Bund* and the *Länder*;
- ❖ The duty to consider the strength of the economy in order to prevent excessive burdens on the taxpayer; and
- ❖ The duty to ensure equal living conditions in the federal territory.<sup>41</sup>

These principles provide some guidance to the legislators, but do not establish objective legal criteria. They thus leave room for political negotiations and choices, for example, the stipulation that the *Bund* and the *Länder* have equal claims to fund their necessary expenditure does not provide an objective measure. It is debatable what "necessary expenditure" can include and clearly leaves scope for subjective political judgements. A convention has developed where the contents of this matter are discussed and agreed upon, at the highest political level between the *Bund* and the *Länder*. The actual division of revenue takes place in terms of what was agreed to.<sup>42</sup>

The unification of Germany in 1990 placed huge demands on the economy of the western part of Germany. An indication of the huge economic disparities between the old and the new *Länder* at the time of unification is the following: the tax capacity of the new *Länder* in 1990 was about 50% of the average of that of the old *Länder*, and the per capita gross domestic product in the new *Länder* was about 30% of the average of that of the old *Länder*.<sup>43</sup> As a result there was a bigger financial need in the East than there was in the West. Due to huge demands and the lack of sufficient capacity, the financial equalisation process could not be extended in its existing format to the new *Länder* at the time of unification. Special arrangements were thus made for the period 1990 to 1994 with a view to implement the financial equalisation process stipulated in the Basic Law throughout the federal territory from 1 January

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<sup>41</sup> Art 106 (3) of the Basic Law; Fischer-Menshausen in Von Münch *GG Komm* 994.

<sup>42</sup> The Federal Chancellor and the Ministers-President of the *Länder* would meet to seek agreement on the issue; Benda et al *Handbuch des Verfassungsrechts* (1983) 884 - 885.

<sup>43</sup> Renzsch *Gegenwartskunde* 1/1994 75; Peffekoven *Wirtschaftsdienst* 1990/VII347.



1995.<sup>44</sup> These arrangements included the establishment of the German Unity Fund that had to substitute the participation of the eastern *Länder* in the financial equalisation process until the end of 1994, and a solidarity tax (*Solidaritätszuschlag*) that was payable on income and corporate tax from 1 January 1995.<sup>45</sup>

In view of the special arrangements governing the period 1990 to 1994, no amendments were made in 1990 to the provisions governing the vertical financial equalisation process. The division of turnover tax between the *Bund* and the *Länder* was thus not altered. When the new financial arrangements were implemented from 1 January 1995, the percentage share of the *Länder* from turnover tax increased to take care of the higher needs of the *Länder*, particularly the needs of the new *Länder*. The changes to the division of turnover tax to the *Bund* and the *Länder* during the first five years after unification are as follows:

<u>Year</u>	<u>Bund</u>	<u>Länder</u>
1989 - 1992	65,0	35,0
1993 - 1994	63,0	37,0
1995	56,0	44,0 <sup>46</sup>

The specific division of revenue from a *Land's* share of income and corporate tax to the individual *Länder* is done according to the principle of place of origin (*Prinzip des örtlichen Aufkommens*). This means that revenue is allocated to a particular *Land* to the extent that the taxes are collected in that particular territory.<sup>47</sup> The idea is that the taxes should be returned to the place where they were economically generated. The application of this principle has led to an unfair distribution of income and corporate tax among the *Länder*, as is evidenced by the influx of corporate tax to the *Land* Hessen due to the fact that all the major banks have their headquarters in Frankfurt in Hessen. This and other unfair consequences of the application of the principle of

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<sup>44</sup> Renzsch *Gegenwartskunde* 1/1994 76; Waigel *Rede des Bundesministers der Finanzen beim Sondersitzungen von Bundesrat und Bundestag am 22. Mai 1990 in Der Vertrag über die Schaffung einer Währungs-, Wirtschafts- und Sozialunion zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik - Erklärungen und Dokumente* (1990) 12 19. These arrangements will be discussed in more detail under 5 5.

<sup>45</sup> Bundesministerium der Finanzen *Steuern von A bis Z* (2001) 90.

<sup>46</sup> Hummel & Nierhaus *Die Neuordnung des bundesstaatlichen Finanzausgleichs im Spannungsfeld zwischen Wachstums- und Verteilungszielen in ifo studien zur finanzpolitik* 54 (1994) 13.

<sup>47</sup> Art 107 (1) of the Basic Law; Arndt *Finanzausgleich* 2; Maunz- Dürig *GG Komm* 107 9.

place of origin were taken care of in the financial reform of 1969, that made provision for a more detailed arrangement in federal legislation to divide part of income tax according to place of residence and corporate tax according to place of location of operations.<sup>48</sup>

The division of turnover tax between the *Bund* and the *Länder* concludes the first stage (vertical financial equalisation) of the financial equalisation process. The next stage is the horizontal financial equalisation after which there is still room for limited vertical equalisation by transfer of additional federal allocations to individual *Länder*.

#### **5 4 2 Horizontal financial equalisation**

This part of the financial equalisation process is not only the most complicated, but also the most important part as it is by way of horizontal financial equalisation that significant changes in the financial position of the *Länder*, including the municipalities, is effected. The principle of federal solidarity is also given expression through horizontal financial equalisation.<sup>49</sup> The complexity of this part of the financial equalisation process was briefly referred to under 5 3 and will be explained in more detail in this section.

The legal foundation for financial equalisation among the *Länder* is provided by Article 107 of the Basic Law and the complementary federal legislation envisaged in that section.<sup>50</sup> As long as there is a need for financial equalisation among the *Länder*, federal legislation that requires the consent of the *Bundesrat* must be adopted to provide the detail of such financial equalisation. The legislation that, until 2004, gave effect to this provision was the *Finanzausgleichsgesetz (FAG)* of 23 June 1993. The main elements of this law, that indicate the different stages in the equalisation process, are the division of turnover tax between the *Bund* and the *Länder*, the financial equalisation between the *Länder* and the supplementary grants from the

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<sup>48</sup> Fuest & Lichtblau *Finanzausgleich im vereinten Deutschland* (1991) 17; Benda et al *Handbuch des Verfassungsrechts* 886.

<sup>49</sup> Arndt *Finanzausgleich* 4; Fischer-Menshausen in Von Münch *GG Komm* 1027.

<sup>50</sup> Hettlage "Die Finanzverfassung im Rahmen der Staatsverfassung" in *Veröffentlichungen der Vereinigung der Deutschen Staatsrechtslehrer Heft 14* (1956) 2 23.

*Bund* to financially weak *Länder*.<sup>51</sup> As a consequence of the judgement of the *Bundesverfassungsgericht* in *BVerfGE* 101, 158 on 11 November 1999, major financial legislative reform had to be undertaken. This included new legislation regarding financial equalisation being developed and becoming effective from 1 January 2005.<sup>52</sup>

The purpose of the financial equalisation legislation is apparent from the wording of Article 107 (2) of the Basic Law, namely, "...ensure a reasonable equalisation of the financial disparity of the *Länder*, due account being taken of the financial capacity and requirements of the municipalities (association of municipalities)". The subject of horizontal financial equalisation is thus the financial capacity of the *Länder*, and includes the revenue of the *Länder* and not their expenditure.<sup>53</sup> In the process of equalising the disparities in financial capacity due account must, however, be taken of the financial requirements of the *Länder*.

The complexity of the horizontal financial equalisation process is emphasised by the elaborate legal provisions in the Financial Equalisation Act, 1993 and the complex set of calculations that give effect to it. The first stage in the process is the division of turnover tax between the *Bund* and the *Länder*, that is determined in Article 1 of the Financial Equalisation Act, 1993 as follows for the years 1995 - 1998:

<u>Year</u>	<u><i>Bund</i></u>	<u><i>Länder</i></u>
1995	56%	44,0%
1996	50,5%	49,5%
1997	50,5%	49,5%
1998	50,5%	49,5%

The next stage in the horizontal financial equalisation process is the division of the *Länder* share of turnover tax between the individual *Länder*. In terms of Article 107 (1) of the Basic Law the *Länder* share of turnover tax must be divided among the

<sup>51</sup> Fischer-Menshausen in Von Münch *GG Komm* 1030.

<sup>52</sup> Bundesministerium der Finanzen "Der neue bundesstaatliche Finanzausgleich ab 2005" *Monatsbericht* 02.2002 (25/02/2002) 1. See discussion of this judgement under 7 3 4.

<sup>53</sup> Häde *Finanzausgleich* 225; *BVerfGE* 72, 330 400.

*Länder* on a per capita basis. Federal legislation may provide that not more than 25% of the *Länder* share of turnover tax is utilised as supplementary payments to financially weak *Länder* whose per capita income from *Land* taxes and from income and corporate tax is below the average of all the *Länder*. This is referred to in the literature as a preceding equalisation (*Vorwegausgleich*).<sup>54</sup> Since this is not an obligation, it provides some discretion for the Federal Parliament to determine the detail of supplementary payments up to a maximum of 25% of the *Länder* share of turnover tax.<sup>55</sup>

The Financial Equalisation Act, 1993 provides in Article 2 that 75% of the *Länder* share of turnover tax must be divided on a per capita basis, while the other 25% must be allocated in accordance with Article 2 (2) of the Financial Equalisation Act, 1993 that stipulates that the *Länder* whose revenue from a list of taxes is lower than 92% of the *Länder* average will get supplementary payments from the *Länder* share of turnover tax to bring their stipulated tax revenue up to a maximum of 92% of the *Länder* average.<sup>56</sup> The balance of the *Länder* share of turnover tax is then distributed on a per capita basis to all the *Länder*. By far the largest part of the *Länder* share of turnover tax is divided on a per capita basis, which means that the key to the division of turnover tax among the *Länder* is the number of inhabitants (*Einwohnerzahl*), this being an objective measure for division.<sup>57</sup>

Some commentators, such as Fischer-Menshausen, regard the division of turnover tax between the *Länder* as part of the primary division of revenue and not as part of the horizontal financial equalisation.<sup>58</sup> Nevertheless, the division of the *Länder* share of turnover tax has a definite horizontal effect although it might be seen in a narrow sense as part of the primary financial equalisation process. It would be appropriate to say that the heart of financial equalisation is the actual *Länder* financial equalisation.

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<sup>54</sup> Fischer-Menshausen in Von Münch *GG Komm* 1033; Fuest & Lichtblau *Finanzausgleich* 18.

<sup>55</sup> Maunz - Dürig *GG Komm* 107 19.

<sup>56</sup> The list of taxes is income tax, corporate tax, business tax and *Land* taxes as determined in the FAG. See Fischer-Menshausen in Von Münch *GG Komm* 1033; Maunz - Dürig *GG Komm* 107 21; Fuest & Lichtblau *Finanzausgleich* 18.

<sup>57</sup> Häde *Finanzausgleich* 225; Maunz - Dürig *GG Komm* 107 19.

<sup>58</sup> Fischer-Menshausen in Von Münch *GG Komm* 1033.

The next step in the financial equalisation process is the actual horizontal financial equalisation, that is based on the provisions of Article 107 (2) of the Basic Law as well as Articles 4 - 10 of the Financial Equalisation Act, 1993. It is in particular this part of financial equalisation that is central to the search for a balance between the autonomy of the *Länder*, which includes the acceptance of differences between them, and the federal solidarity between the *Länder*, that includes the development of equal living conditions.<sup>59</sup>

Horizontal financial equalisation takes place by way of payments by the *Länder* that are bound to make these payments (*ausgleichspflichtige Länder* or contributing *Länder*) to the *Länder* that are entitled to receive these payments (*ausgleichsberechtigte Länder* or receiving *Länder*).<sup>60</sup> A comparison is made of the financial capacity of all the *Länder* in order to determine who the contributing and who the receiving *Länder* must be. Article 107 (2) of the Basic Law states quite clearly that it is the financial capacity of the *Länder* that must be considered, and not only their tax revenue. The financial capacity of the *Länder* includes all their sources of revenue, for example, all fees and other financial contributions paid to them. In this respect, the *Bundesverfassungsgericht* said that the capacity of the *Länder* is based on their total financial position and not only on their tax revenue. If this is not so, it could lead to unfair results where some *Länder* would have to supplement the inadequate tax provision of other *Länder*.<sup>61</sup>

The Financial Equalisation Act, 1993, created two yardsticks for the calculation of the equalisation payments, namely the financial capacity measure (*Finanzkraftmeßzahl*) and the equalisation measure (*Ausgleichsmeßzahl*). The contributing *Länder* are those *Länder* whose financial capacity measure is higher than their equalisation measure in the particular year for which the financial equalisation is done. The receiving *Länder* are those *Länder* whose financial capacity measure is lower than their equalisation measure.<sup>62</sup> The financial capacity measure of each *Land* is the total of all the tax

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<sup>59</sup> Häde *Finanzausgleich* 234; Fischer-Menshausen in Von Münch *GG Komm* 1034; Maunz - Dürig *GG Komm* 107 21.

<sup>60</sup> Art 4 of the *FAG*; Maunz - Dürig *GG Komm* 107 23.

<sup>61</sup> *BVerfGE* 72, 330 398; Häde *Finanzausgleich* 231.

<sup>62</sup> Art 6 (1) of the *FAG*.

revenue of a *Land*, including half of the tax revenue of its municipalities.<sup>63</sup> As the name indicates, this is a measurement of the financial capacity of the individual *Länder*.

The equalisation measure on the other hand is a mathematical average of the total revenue of all the *Länder*. It is calculated by adding together the revenue of the *Länder*, including the *Länder* share of turnover tax and the preceding equalisation from turnover tax, and half of the revenue of the municipalities as stipulated in Articles 7 and 8 of the Financial Equalisation Act, 1993. The result is divided by the total population of the country and multiplied by the number of inhabitants in a *Land* to get the equalisation measure for that particular *Land*.<sup>64</sup>

The calculation of the equalisation benefits, which is further explained below, consists of three steps, namely;

- (i) determination of the financial capacity of a *Land* according to the financial capacity measure;
- (ii) determination of the financial need of a *Land* according to the equalisation measure; and
- (iii) determination of the contributing and receiving *Länder* and the equalisation contributions.<sup>65</sup>

- (i) Determination of the financial capacity of a *Land* according to the financial capacity measure.

In calculating the financial capacity of the individual *Länder* provision is made in Article 7 (3) of the Financial Equalisation Act, 1993, to take special financial burdens into account, for example, the maintenance and improvement of the coastal harbours of Bremen, Bremerhaven, Hamburg, Rostock and Emden. The practical result of this

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<sup>63</sup> Art 6 (1) of the *FAG*; Arndt *Finanzausgleich* 5.

<sup>64</sup> Art 6 (2) of the *FAG*; Fischer-Menshausen in Von Münch *GG Komm* 1040; Arndt *Finanzausgleich* 5; Fuest & Lichtblau *Finanzausgleich* 19.

<sup>65</sup> Fuest & Lichtblau *Finanzausgleich* 19.

stipulation is that the following amounts (1995-figures) must be deducted from the provisional financial capacity of the respective *Länder*:

Bremen	DM 90m
Hamburg	DM 142m
Lower Saxony	DM 18m
Mecklenburg-Pomerania	DM 50m <sup>66</sup>

The financial capacity of the individual *Länder* is therefore the actual total revenue of each *Land* plus half of the revenue of the municipalities, subject to the correction of the harbour burdens of the four above-mentioned *Länder*.

- (ii) Determination of the financial need of a *Land* according to the equalisation measure.

The average equalisation measure, calculated in accordance with Article 8 of the Financial Equalisation Act, 1993, must be multiplied by the number of inhabitants of each *Land*, as valued in terms of Article 9 of the Financial Equalisation Act, 1993, to arrive at the equalisation measure for individual *Länder*. The basic norm in the determination of the financial need of a *Land* is that the per capita financial need is the same in all the *Länder*. This is qualified by a differentiation in the valuation of the inhabitants of the *Länder* and the municipalities. The number of inhabitants of each *Land* is valued at 100%, with the exception of the city-states Berlin, Bremen and Hamburg that are valued at 135%. This higher valuation of population, referred to in the literature as *Einwohnerveredelung* (freely translated as "population valuation"), is based on the premise that communities with a higher population density normally have higher infrastructure expenditure.<sup>67</sup> Based on the same premise, a refinement takes place for the valuation of the number of inhabitants in the communities - the higher the number of inhabitants, the higher the valuation, for example, the first 5 000 inhabitants of a community are valued at 100% while the next 15 000 are valued at

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<sup>66</sup> Art 7 (3) of the *FAG*; Fuest & Lichtblau *Finanzausgleich* 19.

<sup>67</sup> Art 9 (2) of the *FAG*; Arndt 5; Fischer-Menshausen in Von Münch *GG Komm* 1040.

<sup>68</sup> Art 9 (3) of the *FAG*.

110%.<sup>68</sup> The population valuation has the result that the higher the value of the number of inhabitants of a *Land*, the higher will its equalisation measure be.

- (iii) Determination of the contributing and receiving *Länder* and the equalisation contributions.

The next step in the calculation of equalisation benefits is the determination of which *Länder* will qualify as equalisation contributors and which *Länder* will qualify as equalisation recipients. If its financial capacity measure exceeds its equalisation measure, there will be a surplus and such a *Land* will be an equalisation contributor. If the equalisation measure of a *Land* exceeds its financial capacity measure, a deficit exists and such a *Land* will be a receiving *Land*.

The population valuation is a controversial measure in view of its practical effect. The higher valuation of the inhabitants of financially strong *Länder*, for example Hamburg, creates a smaller surplus of the financial capacity measure over the equalisation measure and thus a lesser amount available for equalisation. In two cases before the *Bundesverfassungsgericht*, the Court ruled that the consideration of the particular nature of the city-states by the use of this population valuation is constitutional.<sup>69</sup> In the latest judgement of the *Bundesverfassungsgericht* on financial equalisation the Court, however, questioned the validity of this special measure for population valuation and said that the Federal Parliament had the constitutional duty to adopt a law that provides objective measures treating the *Länder* equally and that the Financial Equalisation Act, 1993, does not in all respects meet this requirement. This constitutional duty includes a re-examination of the population valuation as it appears in Article 9 of the Financial Equalisation Act, 1993.<sup>70</sup>

The calculation of the actual equalisation contributions is done in accordance with a scale stipulated in Article 10 of the Financial Equalisation Act, 1993. On the part of the receiving *Länder*, the equalisation payment is determined as follows:

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<sup>69</sup> *BVerfGE* 72, 415; *BVerfGE* 86, 148.

<sup>70</sup> *BVerfGE* 110, 158 - a judgement of the Second Senate delivered on 11 November 1999.



- ❖ 100% of the deficit financial capacity, if it is less than 92% of the equalisation measure; and
- ❖ 37,5% of the deficit financial capacity, if it falls between 92% and 100% of the equalisation measure.<sup>71</sup>

In the case of the contributing *Länder* the equalisation contributions are determined as follows:

- ❖ If the financial capacity of a *Land* is between 100% and 101% of the equalisation measure, 15% of its surplus must be contributed;
- ❖ If the financial capacity is between 101% and 110% of the equalisation measure, 66% of its surplus must be contributed; and
- ❖ If the financial capacity exceeds 110% of the equalisation measure, 80% of its surplus must be contributed.<sup>72</sup>

The equalisation contributions by the contributing *Länder* are paid into a pool that is distributed among the receiving *Länder* according to the calculations stipulated above. The equalisation surpluses to be paid by the contributing *Länder* are raised or lowered by a factor to make the total equalisation surpluses equal to the total equalisation contributions.<sup>73</sup> The result of the horizontal financial equalisation is an increase in the financial capacity of the financially weak *Länder* to at least 95% of the national average. The following table illustrates the effect of the horizontal financial equalisation on the financial capacity of all the *Länder* in 1995, the first year that financial equalisation was implemented throughout the country.

**Table 5 1: The effect of the *Länder* financial equalisation (1995)<sup>74</sup>**

<i>Land</i>	before equalisation	after equalisation
Hessen	112,2	103,4
Baden-Württemberg	109,7	103,0

<sup>71</sup> Art 10 (1) of the FAG; Fuest & Lichtblau *Finanzausgleich* 21.

<sup>72</sup> Art 10 (2) of the FAG.

<sup>73</sup> Bundesministerium der Finanzen (BMF) *Die Finanzverteilung in der Bundesrepublik Deutschland* (1996) 32.

<sup>74</sup> Bundesministerium der Finanzen *Die Finanzverteilung in der Bundesrepublik Deutschland* 33.

Bavaria	107,7	102,5
North Rhine-Westphalia	107,0	102,3
Hamburg	103,5	102,2
Schleswig-Holstein	102,5	101,2
Lower Saxony	96,2	97,6
Rhineland-Palatinate	96,2	97,6
Saarland	90,9	95,0
Brandenburg	86,6	95,0
Saxony	85,4	95,0
Saxony-Anhalt	85,0	95,0
Thüringen	85,0	95,0
Mecklenburg-Pomerania	84,6	95,0
Bremen	80,9	96,3
Berlin	72,7	95,0

The actual *Länder* contributions and funds received by *Länder* are illustrated in the following table, that also indicates the effect of the inclusion of the new *Länder* in 1995:

**Table 5 2: The *Länder* financial equalisation in 1994 and 1995<sup>75</sup>**  
**[Contributions (-) and receipts (+) are indicated in DM million]**

<u><i>Land</i></u>	<u>1994</u>	<u>1995</u>
<u>Old <i>Länder</i></u>		
Baden-Württemberg	-410	-2 803
Bavaria	-669	-2 532
Bremen	+568	+562
Hamburg	+60	-117
Hessen	-1 827	-2 153
Lower Saxony	+958	+452
North Rhine-Westphalia	+156	-3 449
Rhineland-Palatinate	+657	+229
Schleswig-Holstein	+72	-141

<sup>75</sup> [www.bundesfinanzministerium.de/fag.htm#neuordnung](http://www.bundesfinanzministerium.de/fag.htm#neuordnung) 2001

Saarland	+434	+180
<u>New Länder</u>		
Berlin	none	+4 222
Brandenburg	none	+862
Mecklenburg-Pomerania	none	+771
Saxony	none	+1 773
Saxony-Anhalt	none	+1 123
Thüringen	none	+1 019

The Basic Law does not require a complete equalisation of financial disparities between the *Länder*, but merely a reasonable equalisation of their financial capacity. The use of the word "reasonable" indicates room for decision-making for the Federal Parliament. Complete financial equalisation will cause absolute equality (*Nivellierung*), that will violate the autonomy and own financial responsibility of the *Länder*.<sup>76</sup> Some protection against absolute equality is built into the Financial Equalisation Act, 1993, namely, the so-called guarantee clauses in Article 10 (3) to (5). Receiving *Länder* are guaranteed a minimum equalisation of their financial capacity to 95% of the *Länder* average in terms of Article 10 (3) of the Financial Equalisation Act, 1993. Articles 10 (4) and (5) provide guarantees to the contributing *Länder* against excessive contributions by them and for the preservation of their original ranking of financial capacity. The question of what a reasonable equalisation really means in practice, has been central to many political debates both inside as well as outside the *Bundesrat*, and has also been considered by the Court.

When confronted with this question in the most recent case regarding the matter, the *Bundesverfassungsgericht* confirmed the prohibition against an absolute equalisation in 1999, when the Court *inter alia* stated that the constitutional obligation to ensure a reasonable and not an absolute equalisation of the financial capacity of the *Länder*, prohibits a reversal of the financial capacity ranking of the *Länder* within the framework of horizontal equalisation.<sup>77</sup> The reasonable equalisation in terms of Article 107 (2) of the Basic Law has the effect of reducing the gap between all the

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<sup>76</sup> *BVerfGE* 86, 215; Arndt *Finanzausgleich* 88; Maunz-Dürig *GG Komm* 107 30.

<sup>77</sup> *BVerfGE* 101, 158. See discussion under 7 3 4.

*Länder* without erasing it. The Court confirmed this important cornerstone of the financial equalisation process and stated that the application of the federal solidarity duty reduces the differences in financial capacity of the *Länder*, but does not eliminate it.

### 5 4 3 Additional grants

The last stage of the financial equalisation process is the possible payment of additional grants (*Bundesergänzungszuweisungen*) by the *Bund* to financially weak *Länder*. Provision is made in the last part of Article 107 (2) of the Basic Law that the federal legislation on financial equalisation may include provisions dealing with the payment of additional federal grants to financially weak *Länder*, "to complement the coverage of their general financial requirements". These additional grants may be determined on two grounds, namely to assist in the covering of a general financial deficit (*Fehlbetrags-Bundesergänzungszuweisungen*) or to assist in the payment for special needs (*Sonderbedarfs-Bundesergänzungszuweisungen*).<sup>78</sup> These grants are not conditional, but are general grants made available to the receiving *Länder* to use at their discretion. In comparison to the rest of the financial equalisation process, these additional grants play a subsidiary role. This is the last part of the process where additional adjustments can be made to the vertical financial equalisation.

Article 11 of the Financial Equalisation Act, 1993, contains detailed provisions for the payment of additional grants by the *Bund* to financially weak *Länder*. Provision is initially made to assist those *Länder* whose financial capacity is, after financial equalisation, still very low. Additional grants, of a maximum of 90% of the difference between the financial capacity measure, and the equalisation measure may be paid to the *Länder* that qualify.<sup>79</sup> While the horizontal financial equalisation is aimed at bringing the financial capacity of all the *Länder* to a comparable level, the additional federal grants to cover general financial deficits are aimed at assisting those individual *Länder* whose financial capacity is still very low.<sup>80</sup> The horizontal financial equalisation should result in bringing the financial capacity of the financially

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<sup>78</sup> Art 11 of the FAG; Häde *Finanzausgleich* 241; Fischer-Menshausen in Von Münch GG *Komm* 1041.

<sup>79</sup> Art 11 (2) of the FAG.

<sup>80</sup> Häde *Finanzausgleich* 242.

weak *Länder* to at least 95% of the *Länder* average. In addition to this more general equalisation, the *Bund* is responsible through its additional grants to raise the financial capacity of the financially weak *Länder* to 99,5% of the *Länder* average.<sup>81</sup> It may, however, not have the effect of increasing the financial capacity of financially weak *Länder* to a higher level than the *Länder* average, since that would be in violation of the prohibition against absolute equalisation (*Nivellierung*).<sup>82</sup>

Additional allocations on the basis of special needs are further made to a list of *Länder* who have above average special financial burdens of government.<sup>83</sup> These include special allocations to cover above-average administration costs, to reduce special financial burdens due to the previous division of Germany, and for budget consolidation purposes. This last category of special needs is aimed at the repayment of debt to the benefit of Bremen and Saarland.<sup>84</sup> The general financial requirements of the *Länder* and of the municipalities are taken into account for purposes of the horizontal financial equalisation. This is done in terms of the first part of Article 107 (2) of the Basic Law, without allowing for special needs of individual *Länder*. In contrast, the provision for additional grants by the *Bund* clearly allows for special needs of individual *Länder* to be considered.<sup>85</sup> The additional grants paid by the *Bund* in terms of Article 107 (2) of the Basic Law and Article 11 of the Financial Equalisation Act, 1993, account for approximately 2% of the revenue from turnover tax.<sup>86</sup> The smaller *Länder*, such as Saarland and Bremen, and the new *Länder* from the East are the main beneficiaries of additional federal grants. Berlin, that has a history of being a divided city that existed in two separate states, became the new capital of the unified Germany. Berlin was partly an old *Land* and partly a new *Land* while also the capital city. In view of its history and its new position of being the capital, huge reconstruction of the city had to be undertaken. To address these special

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<sup>81</sup> Häde *Finanzausgleich* 243.

<sup>82</sup> *BVerfGE* 72, 330 (405); *BVerfGE* 101, 158. See discussion under 7 3 2 and 7 3 3.

<sup>83</sup> Art 11 (3) - (6) of the *FAG*; Fischer-Menshausen in Von Münch *GG Komm* 1042; *BVerfGE* 72, 330 402; *BVerfGE* 86, 148 270.

<sup>84</sup> Saarland, one of the smaller *Länder*, only started to participate in the financial equalisation process in 1961. See Peffekoven "Finanzausgleich im vereinten Deutschland" in *Wirtschaftsdienst* 1990/VII 346 349.

<sup>85</sup> Häde *Finanzausgleich* 245.

<sup>86</sup> Fuest & Lichtblau *Finanzausgleich* 24.

needs, Berlin receives special financial assistance in terms of the Federal Consolidation Program introduced on 23 June 1993.<sup>87</sup>

In the 1999-judgement in the *Bundesverfassungsgericht* on financial equalisation the Court considered the application of the provisions concerning additional grants and stated that through the payment of additional federal grants the financial capacity of the financially weak *Länder* must be raised in such a way that the financial capacity of the receiving *Länder* does not exceed the *Länder* average.<sup>88</sup> With specific reference to the special financial assistance to Bremen and Saarland, the Court stated that Article 11 (6) of the Financial Equalisation Act, 1993, was only a temporary measure aimed at helping Bremen and Saarland to help themselves. This assistance had to be reduced over time in order to end this particular additional grant in 2004. The Court ruled the Financial Equalisation Act, 1993, to be unconstitutional and said that it could still apply as a transitional measure, but that new legislation that must comply with the requirements of Articles 106 and 107 of the Basic Law should be in place by 1 January 2005.<sup>89</sup>

## **5 5 Effect of unification on financial equalisation**

The unification of Germany in 1990 created a new Federal Republic of Germany consisting of sixteen *Länder*, namely, eleven from the West and five from the East. The five new *Länder* are Brandenburg, Mecklenburg-Pomerania, Saxony, Saxony-Anhalt and Thüringen while Berlin (West Berlin was already part of the Federal Republic of Germany) was enlarged by the addition of East Berlin. In terms of the unification, two fundamentally different economic systems had to be merged into one. Incorporating the economies of these new *Länder* into that of the Federal Republic of Germany while protecting the interest of the old *Länder* was a daunting task.

It was evident that the financial and economic unification process could not be done at once and that an incremental process was required. The Unification Treaty therefore

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<sup>87</sup> *Gesetz zur Umsetzung des Föderale Konsolidierungsprogram (FKPG) vom 23. Juni 1993*; Renzsch *Gegenwartskunde* 1/1994 77, 79; Weinzen *Berlin* 298 – 301.

<sup>88</sup> *BVerfGE* 101, 158.

<sup>89</sup> Spahn “The German Constitutional Court takes on the principle of ‘solidarity’” 2001 (Vol 1 nr 1) *Federations* 1.

envisaged a two-phase process. The first phase introduced, in accordance with Article 7 of the Unification Treaty, special financial arrangements for the new *Länder* that would apply till the end of 1994. In terms of the second phase, new arrangements for the financial intergovernmental relations between the *Bund* and the *Länder*, including the *Länder* financial equalisation, would be implemented from 1 January 1995.<sup>90</sup> This phased in process was aimed at gradually increasing the financial and economic capacity of the new *Länder* to allow them to reach a comparable level to that of the old *Länder*. Selmer suggested that there should be a third phase, that could take place after a transitional period of about 10 years when a new federal financial constitution should be under consideration.<sup>91</sup>

In terms of the first phase of financial arrangements to give effect to the Unification Treaty, a special fund, the German Unity Fund (*Fonds Deutsche Einheit*), was established.<sup>92</sup> The total funds made available to provide financial assistance to the development of the new *Länder* amounted to DM 115 billion over a period of almost five years. The funds were partially obtained through savings from the *Bund*, while most of it (DM 95 billion) was obtained through credit, with the *Bund* and the *Länder* responsible for equal portions.<sup>93</sup> The credit financing is paid for by way of an annual subsidy by both the *Bund* and the *Länder*. There is an understanding that the total debt should be paid off by 2018.<sup>94</sup> The individual *Länder* contributed to this funding by way of a special per capita levy (*Solidaritätszuschlag*), which totalled DM 1 000 m in 1991, the first year they had to pay it.<sup>95</sup>

During the period from 1990 to the end of 1994, special attention was thus paid to the economic upliftment of the former *Deutsche Demokratische Republik* with the main instrument for this being the German Unity Fund. This was a drastic measure that placed huge demands on the western part of Germany, but it was also a transitional

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<sup>90</sup> Art 31 *Gesetz zu dem Vertrag vom 18. Mai 1990 über einer Währungs-, Wirtschafts- und Sozialunion zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik vom 25. Juni 1990*, (*Gesetzes zum Staatsvertrag*) BGBl 1990 II 518.

<sup>91</sup> Selmer *Die gesetzliche Neuordnung der bundesstaatlichen Finanzbeziehungen* in Andel (Hrsg.) et al *Finanz Archiv* (1994) 331 332.

<sup>92</sup> Art 31 of the *Gesetzes zum Staatsvertrag*.

<sup>93</sup> Art 31 of the *Gesetzes zum Staatsvertrag*; Peffekoven *Wirtschaftsdienst* 1990/VII 346.

<sup>94</sup> Art 31 (6) of the *Gesetzes zum Staatsvertrag*; Peffekoven *Wirtschaftsdienst* 1990/VII 346.

<sup>95</sup> Peffekoven *Wirtschaftsdienst* 1990/VII 347.

measure. The new *Länder* had to be prepared for inclusion into the financial intergovernmental relations system as provided for in Articles 106 and 107 of the Basic Law. The constitutional aim of providing equal living conditions throughout the federal territory was extended after unification to include the new *Länder*. Due to the fact that they had a much higher financial need than the western *Länder* and a very low financial capacity, an immediate inclusion in the financial equalisation system, which focuses on financial need as well as financial capacity, was not feasible. The bridge to get to the start of a new financial equalisation process in 1995 was the German Unity Fund.

A new federal law was passed in 1993, after a meeting of the Federal Chancellor and the Ministers-President of the *Länder*. In terms of this a program for financing the new *Länder* from 1995 was adopted.<sup>96</sup> Article 33 of this Law, that was the main element of a financial consolidation program, stipulated that the new arrangements for financial equalisation must be applied from 1 January 1995. While it kept the basic structure of the financial equalisation process the same, a number of changes were made to the Financial Equalisation Act, 1993. The more important changes are listed below:

- (i) All the *Länder*, including the unified Berlin, were included in the financial equalisation process from 1 January 1995 without any amendments to the Basic Law.<sup>97</sup>
- (ii) The *Länder* share of turnover tax was increased in 1995 to 44% compared to 37% in 1994 in order to alleviate the disproportionate burdens of the old *Länder* in the financial equalisation process.<sup>98</sup>
- (iii) In calculation of the equalisation measure a population valuation figure of 135% was used for Berlin, being a city-state.

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<sup>96</sup> *Föderale Konsolidierungsprogram (FKPG) vom 23. Junie 1993.*

<sup>97</sup> In view of the division of Berlin after World War II, West-Berlin received special treatment by the Federal Republic of Germany from 1949 till 1990 as far as the financial equalisation in terms of the Basic Law is concerned. See Hidién "Der finanzrechtliche Status des Landes Berlin im bundesstaatlichen Finanzausgleich des Grundgesetzes von 1949 bis 1995" in 1998 (4) *Landes - und Kommunalverwaltung (LKV)* 135; Weinzen *Berlin und seine Finanzen* (1995) 298 - 300.

<sup>98</sup> Art 33 1 (1) of the FKPG; Renzsch *Gegenwartskunde* 1/1994 78.



- (iv) The horizontal financial equalisation would from 1 January 1995 provide to all the *Länder* a minimum financial capacity of 95% of the *Länder* average.<sup>99</sup>
- (v) The financial capacity ranking of the individual *Länder* after horizontal financial equalisation would be protected.<sup>100</sup>
- (vi) Specific provision was made for additional grants to the financially weak *Länder*, that were mainly the new *Länder*. This was to compensate for financial deficits that remained after horizontal equalisation and for special burdens resulting from the previous division of Germany.<sup>101</sup> Bremen and Saarland were still the main beneficiaries of additional federal grants among the old *Länder*.

The inclusion of all the *Länder* in the financial equalisation process had a significant financial impact on both the contributing and the receiving *Länder*. While the new *Länder* all benefited from the new financial arrangements, the financially weak old *Länder* found themselves in financially more difficult positions than before, as they could not easily claim contributions from the financial equalisation process any more.

It was evident, already at the beginning of the unification process, that major economic reform and development was needed over a couple of years to reconstruct and develop the area previously known as the *DDR*. The Unification Treaty captured this view, inter alia in Article 1, by stating that the basis for the economic union between the two parties is the building of a social market economy.<sup>102</sup> The level of economic development in a specific geographic area, for example, a community or *Land*, has a direct impact on the taxes raised within that area. This in turn impacts on the financial capacity of that particular *Land*. In view of the fact that the financial equalisation process focuses on financial capacity and financial needs, it is important

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<sup>99</sup> Art 33 10 (3) of the *FKPG*; Häde *Finanzausgleich* 278; Renzsch *Gegenwartskunde* 1/1994 78. The effect of this provision in the first year of application (1995) is illustrated in Table 1.

<sup>100</sup> Art 33 10 (3) of the *FKPG*.

<sup>101</sup> Art 33 11 of the *FKPG*.

<sup>102</sup> Art 1 (2) of the Unification Treaty: “*Grundlage der Wirtschaftsunion ist die Soziale Marktwirtschaft als gemeinsame Wirtschaftsordnung beider Vertragsparteien. Sie wird insbesondere bestimmt durch Privateigentum, Leistungswettbewerb, freie Preisbildung und grundsätzlich volle Freizügigkeit von Arbeit, Kapital, Gütern und Dienstleistungen;...*”

that attention be paid to the economic development of the unified Germany, but in particular also to the economic development of the new *Länder*.

The second phase of the financial arrangements pertaining to the Unification Treaty did not only signify important financial reforms by the inclusion of all the *Länder* in the financial equalisation process, it also led to an array of economic and political discussions on the economic development of the whole country.<sup>103</sup> These included discussions and reform proposals by individual *Länder* as well as by the federal Ministry of Finance. The two major financial constitutional reforms since the establishment of the Federal Republic of Germany in 1949 took place after specifically tasked commissions produced reports on fundamental questions relating to the financial constitution.<sup>104</sup> In case of the unification of Germany that route was not followed and the basis for financial constitutional reform was laid in Articles 5 and 7 of the Unification Treaty, these provided for the establishment of the *Fonds Deutsche Einheit* and the new financial arrangements incorporating all the *Länder* from 1 January 1995. The reform measures did not incorporate any amendments to the Basic Law, but did require a number of legislative amendments and some new legislation.

The inclusion of the new *Länder* into the financial equalisation process led to an increase in the volume of equalisation contributions, but also raised questions about the stipulations and functioning of the financial equalisation process, in particular regarding some aspects of the Financial Equalisation Act, 1993. Two of the financially strong *Länder*, namely, Bavaria and Baden-Württemberg, took the lead in debating the issues that concerned them. They argued for a major reform of the financial equalisation process.<sup>105</sup> This led to a case before the *Bundesverfassungsgericht* where these two *Länder* and Hessen contested the constitutional validity of a number of the provisions of the Financial Equalisation Act, 1993.<sup>106</sup> Although the whole financial equalisation process was under scrutiny, the

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<sup>103</sup> Selmer *Die gesetzliche Neuordnung* 333.

<sup>104</sup> Selmer *Die gesetzliche Neuordnung* 334; Eckertz "Der gesamtdeutsche Finanzausgleich im System des geltenden Verfassungsrechts" *Die Öffentliche Verwaltung* 46. Jahrgang 1993 (7) 281 282.

<sup>105</sup> Bayerisches Staatsministerium der Finanzen *Die Reform des Finanzausgleichs - Föderale, ökonomische und verfassungsrechtliche Aspekte* (1998) 1.

<sup>106</sup> *BVerfGE* 101, 158. The case will be discussed in more detail in **Ch 7**.

main issues regarding the *Länder* complaints were the population valuation that benefited the city-states and the overall result of financial equalisation that, so it was argued, caused an absolute equalisation of financial capacity of the *Länder*. The *Bundesverfassungsgericht* held that the constitutional obligation to achieve a reasonable equalisation of the financial capacity of the *Länder* meant that the gap in financial capacity between the *Länder* would be narrowed but not closed. An absolute equalisation was thus unconstitutional. The Court further said that the population valuation had to be re-examined by the legislator, which had the constitutional duty to regulate financial equalisation in a way that treats all the *Länder* fairly.

## **5 6 Financial legislative reform**

The *Bundesverfassungsgericht*, in its judgement of 11 November 1999, ruled that the *Finanzausgleichgesetz*, 1993, did not comply with all the requirements of Articles 106 and 107 of the Basic Law and directed the Federal Parliament to develop a new legislative framework for regulating financial equalisation.<sup>107</sup> The Court, however, ruled that the current financial equalisation legislation should be treated as a transitional measure until 1 January 2005 when the new legislation must be implemented. In order to give effect to the Court's decision, the Federal Government and the Ministers-President of the 16 *Länder* on 23 June 2001 agreed to a revised financial equalisation process and a new solidarity agreement (*Solidarpakt II*) between the old and new *Länder* aimed at the economic and social development of the new *Länder*.<sup>108</sup> After the scheduled end of the first solidarity agreement on 31 December 2004, the second solidarity agreement will be in operation from 1 January 2005 for the next 15 years. At this time the new financial equalisation arrangements will take effect. These arrangements include a standards act (*Maßstäbengesetz*) that will provide measures or norms according to which the actual financial equalisation must be done and a new financial equalisation law which will cover the detailed

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<sup>107</sup> BVerfGE 101, 158 para C II.1 - 4. See discussion under 7 3 4.

<sup>108</sup> Anon "Bundesregierung und Länder einigen sich auf Länderfinanzausgleich und Solidarpakt II" [www.bundesregierung.de/dokumente/Themen\\_A-Z/Aufbau-Ost-.6771/Laenderfinanzausgleich-und-Sol.htm](http://www.bundesregierung.de/dokumente/Themen_A-Z/Aufbau-Ost-.6771/Laenderfinanzausgleich-und-Sol.htm)

division of funds and the equalisation effects thereof.<sup>109</sup> The aim of this legislative reform is not only to give effect to the Court's decision, but also, and perhaps more importantly, to give effect to the constitutional requirement of the provision of equal living conditions in the eastern and the western *Länder*.

The two-phased legislative approach as directed by the Court is criticised by some commentators. Kämmerer stated that there is no constitutional basis for the creation of a standards act (*Maßstäbengesetz*) with a superior legislative status.<sup>110</sup> Such approach suggests a hierarchy of laws that is not prescribed, nor envisaged, in Articles 106 and 107 of the Basic Law. The Basic Law is the supreme law in Germany and all legislation must be measured against it. The new Standards Act is equal in status to the Financial Equalisation Act and cannot have a superior status. The Federal Parliament thus followed a constitutionally questionable process and should rather have opted for one law consisting of two parts, namely a set of standards, as required by the Court, complemented by the actual financial equalisation provisions in the second part of the same law.<sup>111</sup>

The Standards Act, 2001, passed by the *Bundestag* and the *Bundesrat*<sup>112</sup> consists of the following elements:

- ❖ Provisions regarding the vertical division of turnover tax (*Umsatzsteuerverteilung*) (Articles 3 – 6);
- ❖ Provisions regarding the *Länder* financial equalisation. The population valuation is set as the criterion for determining the financial capacity of a *Land*. (Articles 9 and 10); and

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<sup>109</sup> Bundesministerium der Finanzen *Monatsbericht* 02.2002 (25/02/2002) 99. This will be discussed in detail in **Ch 8**.

<sup>110</sup> "Maßstäbe für den Bundesfinanzausgleich? – Dramaturgie einer verhinderten Reform" *JuS* (2003) Heft 3 214 215; Kämmerer *Föderalismus als Solidarprinzip* in Vitzthum & Winkelmann (hrsgs) *Bosnien-Herzegovina im Horizont Europas – Demokratische und föderale Elemente der Staatswerdung in Südosteuropa* (2003) 195 - 199.

<sup>111</sup> Kämmerer *Föderalismus als Solidarprinzip* 207 n 51.

<sup>112</sup> *Gesetzes über verfassungskonkretisierende allgemeine Maßstäbe für die Verteilung des Umsatzsteueraufkommens, für den Finanzausgleich unter den Ländern sowie für die Gewährung von Bundesergänzungszuweisungen (Maßstäbengesetz vom 21. November 2001)*.

- ❖ Provisions regarding the additional federal allocations (*Bundesergänzungszuweisungen*), with a specific reference to the need to address the financial and economic situation of Berlin and the new *Länder* (Articles 12 – 14).<sup>113</sup> The Standards Act also stipulates that the *Bundesergänzungszuweisungen* should always be seen as a complementary financial aid to the financially weak *Länder* and that it should form a small percentage of the total financial equalisation.

The Federal Parliament attempted to give effect to the directions given by the *Bundesverfassungsgericht* and used some of the wording of the judgement of 11 November 1999, but failed to provide the objective standards, envisaged by the Court, on which the actual financial equalisation should be based.<sup>114</sup> It seems that the basis for the new financial equalisation is not the Standards Act, but an agreement between the *Bund* and the *Länder* concerning the various elements of the financial equalisation process. The *Finanzausgleichgesetz* (Financial Equalisation Act), 2001,<sup>115</sup> was in fact part of a package of financial reform arrangements agreed upon between the *Bund* and the *Länder*.

The new Financial Equalisation Act, 2001, follows the general pattern of the previous Financial Equalisation Act, 1993, but is further characterised by the following elements, namely:

- ❖ Incentives for the *Länder*. The introduction of a *Prämienmodell* (bonus system) in terms of which the *Länder* with a per capita tax increase, that is more than the average per capita tax increase, can exclude such tax increase from the financial equalisation process.<sup>116</sup> This innovation supports competition amongst the *Länder*, and the contributing *Länder* receive a guarantee that they will retain part of their increase in tax revenue.

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<sup>113</sup> Bundesministerium der Finanzen “Das Maßstäbengesetz – Neuregelung der Grundlagen des bundesstaatlichen Finanzausgleichs” *Monatsbericht* 09. 2001 67 68.

<sup>114</sup> Kämmerer 2003 (3) *JuS* 215; Kämmerer *Föderalismus als Solidarprinzip* 212 – 216.

<sup>115</sup> *Finanzausgleichgesetzes* von 20. Dezember 2001.

<sup>116</sup> Bundesministerium der Finanzen *Der neue bundesstaatliche Finanzausgleich* 100; Kämmerer *Föderalismus als Solidarprinzip* 218.

- ❖ Recognition of federal solidarity amongst the *Länder* and between the *Bund* and the *Länder*, by way of increased support for financial aid to and economic development of the new *Länder*. This is evidenced by the substantial additional federal allocations to Berlin and the new *Länder* determined for the period 2005 – 2019 in terms of the *Solidarpakt II*, namely an amount of euro 105 billion over 15 years.<sup>117</sup> Furthermore, in addition to the higher population valuation of the city-states in the horizontal financial equalisation, a population valuation of higher than 100% is introduced for the *Länder* Mecklenburg-Pomerania, Brandenburg and Saxony-Anhalt.<sup>118</sup>
- ❖ The provision of a long-term financial equalisation plan. This Act stipulates that it will be valid from 2005 till 2019, which provides certainty in terms of financial planning.

It remains to be seen whether the Standards Act, 2001, and the new Financial Equalisation Act, 2001, will reduce the number of court applications regarding financial equalisation. While the Federal Parliament attempted to give effect to the judgement of the *Bundesverfassungsgericht*, it is clear that there are quite a few constitutional question marks about the new legislation and it is quite possible that it will be the subject of a court application long before the end of its predetermined lifespan.

## 57 Conclusion

The federal state principle (*Bundesstaatprinzip*) contained in Article 20 of the Basic Law is one of the pillars of the German federal system, and it is given practical application in the particular division of powers between the various constituent units within the whole state. The federal state principle as well as the federal financial equalisation contains an inherent tension between diversity and unity. This implies on the one hand the recognition of the diversity of *Länder*, each with its own characteristics and financial capacity, while they are on the other hand united in one

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<sup>117</sup> Bundesministerium der Finanzen *Der neue bundesstaatliche Finanzausgleich* 101; Kämmerer *Föderalismus als Solidarpinzip* 220.

<sup>118</sup> These three eastern *Länder* will get a population valuation of between 102 and 105% in view of the fact that they are not so densely populated. See Bundesministerium der Finanzen *Der neue bundesstaatliche Finanzausgleich* 100; Kämmerer *Föderalismus als Solidarpinzip* 220.

federal state where financial equalisation implies some degree of redistribution of financial resources. The application of the federal state principle requires a weighing up of two opposing aims, namely that of autonomy (diversity) and solidarity (unity).<sup>119</sup> The tension between diversity and unity is recognised by the Basic Law, that provides for the financial autonomy of both the *Bund* and the *Länder*, while at the same time determines that there must be financial equalisation between the various constituent units of the Federation.<sup>120</sup> The principle of *Bundestreue* guides the *Bund* and the *Länder* in their financial relations and implies in practice that they have a duty to assist each other.

The application of the federal state principle to the financial intergovernmental relations implies that through financial equalisation there must be a process aimed at creating a balance in the financial position of the *Bund* vis-à-vis that of the *Länder*, and among the individual *Länder*.<sup>121</sup> Although the financial equalisation among the *Länder* is aimed at creating equal living standards throughout the country, this must be done within limits and cannot lead to a situation of absolute equality (*Nivellierung*). The asymmetry between the *Länder* and their autonomy must therefore be recognised.

Although the structure of financial equalisation is quite simple, consisting of three elements, namely vertical financial equalisation, horizontal financial equalisation and additional federal grants to individual *Länder*, this analysis shows that the financial equalisation process itself is quite complex. Pleas to simplify the financial equalisation legislation have so far not been successful. An opportunity to provide a simpler set of rules was lost when the Federal Parliament enacted the new *Finanzausgleichgesetz*, 2001, that is still too complicated.

While the vertical financial equalisation is a stable predictable allocation of funds between the *Bund* and the *Länder*, horizontal financial equalisation consists of a complex set of rules that leads to results where the constitutional correctness may be questioned. It is in particular the constitutional obligation to ensure a "reasonable

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<sup>119</sup> Selmer *Die gesetzliche Neuordnung* 341.

<sup>120</sup> Art 104a (1), 106, 107 and 109 (1) of the Basic Law; Häde *Finanzausgleich* 256.

<sup>121</sup> *BVerfGE* 72, 330 383.

equalisation of the financial disparity of the *Länder*" that is continuously under scrutiny. Financially strong *Länder*, such as Hessen, Baden-Württemberg and Bavaria, have in the past questioned the application of this provision in practice.<sup>122</sup> The *Bundesverfassungsgericht* made it quite clear that it does not mean an absolute equalisation of financial capacity, but merely a reasonable equalisation of the financial capacity of the various *Länder*.<sup>123</sup> In practical terms, it also means that the ranking of the *Länder* in terms of their financial capacity should not be changed due to horizontal financial equalisation.

Although financial equalisation is on the one hand a mechanical process where mathematical calculations direct the process, there is another very important substantive side to it. The essence of financial equalisation is about giving effect to the constitutional provisions regarding the development of equal living conditions throughout the country and the reasonable equalisation of financial disparities between the *Länder*. These concepts do not have fixed boundaries and change over time, for example, equal living conditions during the first few years after 1949 were quite different from what they are today. It is evident that the constitutional aim of creating equal living conditions throughout the country is not attached to a specific time limit, but it suggests a continuous endeavour by both the *Bund* and the *Länder* to improve the quality of life of the citizens throughout the country. By the inclusion of this aim in the Basic Law, the importance of the purpose of financial equalisation is confirmed and must be adhered to at all times irrespective of which political party is in power.

The unification of Germany placed heavy burdens on both the *Bund* and the old *Länder*. This was not only politically justified, since it was an inevitable consequence of the Unification Treaty, but it was also constitutionally justified in terms of the federal state principle and the constitutional obligation to ensure equal living conditions in all the *Länder*. The economic woes of the new *Länder* still require a lot of attention and may be the reason why a new solidarity agreement (*Solidarpakt II*) will be implemented from 1 January 2005.

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<sup>122</sup> These three *Länder* were the main parties in the 1999-case about financial equalisation that was before the *Bundesverfassungsgericht* (BVerfGE 101, 158).

<sup>123</sup> BVerfGE 101, 158.



The incorporation of all the *Länder* in the financial equalisation process since 1 January 1995, has highlighted some difficulties in the implementation of the financial equalisation system. Some of the elements of financial equalisation previously questioned by the financially strong *Länder*, such as the population valuation and the effect of horizontal equalisation on the ranking of the financial capacity of the individual *Länder*, were often under the spotlight since 1995. The inherent tension in financial equalisation between the constitutionally recognised autonomy of the *Länder* and their solidarity duty to assist one another as members of a united Germany requires a continuous balancing of interests. This tension became even more acute since 1995, when the volume of financial equalisation contributions increased sharply and the problems with the system became more visible.<sup>124</sup>

The *Bundesverfassungsgericht* gave some direction for legislative reform in its 1999 judgement on financial equalisation, although it was criticised for acting too much like a legislator.<sup>125</sup> While it confirmed the constitutional pillars of financial equalisation, it also directed the Federal Parliament to reform the Financial Equalisation Act, 1993, in order to comply with the requirements in Articles 106 and 107 of the Basic Law. The Court in this judgement pleaded for a simpler law and a simpler financial equalisation process. The agreement between the *Bund* and the *Länder* on 23 June 2001 to develop a new regulatory framework for financial equalisation is the first significant reform of the financial equalisation system since the unification of Germany. These financial equalisation reform measures were complemented by a new solidarity agreement (*Solidarpakt II*) aimed at the reconstruction and economic development of the new *Länder*. Whether the new *Maßstäbengesetz* and the *Finanzausgleichgesetz*, 2001, would survive an onslaught in the *Bundesverfassungsgericht* is still to be seen. It is, however, evident that there will always be a need to find a balance between the recognition of financial autonomy of the *Länder* and solidarity among the *Länder*. This search may lead to applications before the *Bundesverfassungsgericht*.

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<sup>124</sup> Bayerisches Staatsministerium der Finanzen *Die Reform des Finanzausgleichs* 1.

<sup>125</sup> *BVerfGE* 101, 158; Kämmerer *Föderalismus als Solidarprinzip* 200.

## **6 Financial equalisation in South Africa**

### **6 1 Introduction**

### **6 2 Purpose of financial equalisation**

### **6 3 The financial equalisation process**

#### **6 3 1 Vertical financial equalisation**

#### **6 3 2 Horizontal financial equalisation**

#### **6 3 3 Additional grants**

### **6 4 A comparative analysis**

### **6 5 Conclusion**

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## **Chapter 6 Financial equalisation in South Africa**

### **6 1 Introduction**

When the new democratic South Africa was established in 1994 a major feature of the economic state of affairs in the country was the existence of huge disparities between the various provinces and between various classes within the community. According to research done in 1998 the poorest 40% of the population earned only 11% of the income, while the wealthiest 10% of the population earned about 40% of the income.<sup>1</sup> The diverse geographic, demographic and economic features of the nine provinces confirm the inequalities of their financial capacity. This is manifested inter alia in different quality of living conditions in the various parts of the country. The new constitutional system reflected both a vertical imbalance that is, a disparity between expenditure responsibilities and revenue-raising powers, and a horizontal imbalance, that is, a difference in financial capacity of the various provinces.<sup>2</sup> These imbalances had to be addressed. Particular financial arrangements in terms of which provision is made for some form of financial equalisation were required. Redistribution of wealth is important in the promotion of political stability and socio-economic development, and in a decentralised system of government this is inter alia done by financial

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<sup>1</sup> Momoniat *Fiscal Decentralisation in South Africa: a Practitioner's Perspective* (2001) 2.

<sup>2</sup> Mokgoro *Interprovincial Fiscal Equalization: The Role of the Financial and Fiscal Commission* in De Villiers (ed) *Birth of a Constitution* (1994) 282.

equalisation among the constituent units.<sup>3</sup> The financial equalisation system in South Africa is a crucial part of the constitutional system and warrants focussed attention.

As discussed in **Chapter 4**, the distribution of constitutional obligations and financial resources to the Federation and the *Länder* in Germany and the national, provincial and local governments in South Africa, is done in such a way that there is a need for sharing of revenue or financial equalisation. In both these countries supremacy of the constitution is a fundamental principle of the constitutional system. This implies that the legal arrangements pertaining to revenue sharing or financial equalisation must be measured against this principle.

This chapter will provide a detailed account of the development of the system of financial equalisation implemented in South Africa since 1994. A comparison will be made between financial equalisation as developed and implemented in Germany and the newly developed system of financial equalisation in South Africa. The purpose of this is to ascertain what lessons could be learnt from the experience of Germany. In a comparative study it is not only important to analyse the individual country studies, but it is also useful to do a direct comparison of particular elements of financial equalisation in the countries. While the German financial equalisation system evolved over a long period of time, the South African system was created quite recently. The comparison with Germany is not a snapshot of the current situation, but one that will provide valuable insight regarding the functioning of the financial equalisation system under various economic and political conditions.

## **6 2 Purpose of financial equalisation**

In order to understand the purpose of financial equalisation in the South African context, it is necessary to refer to the Constitutional Principles that formed the basis of the current South African Constitution. While the Constitutional Principles in general influenced the shaping of the structure of government and the accompanying allocation of powers and functions, there are three particular Constitutional Principles that influenced the development of the "financial constitution", namely Constitutional

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<sup>3</sup> Musgrave *Public Finance* 414.

Principles XXV, XXVI and XXVII.<sup>4</sup> These Constitutional Principles are well reflected in the Constitution and sections 214, 227, 228, 229 and 230 are noteworthy in this respect.

In accordance with Constitutional Principle XXV the fiscal powers and functions of the national and provincial governments must be defined in the Constitution while the constitutional framework for local government shall include appropriate fiscal powers for the different categories of local government. Constitutional Principle XXVI states clearly that each level of government shall have a constitutional right to an equitable share of revenue collected nationally to enable them to provide basic services and to exercise their allocated functions. This is in line with economic theory that suggests sufficient allocation of financial resources to the various levels of government to allow them to perform the public services or functions allocated to them.<sup>5</sup> Constitutional Principle XXVII recognises the particular South African context when it refers to "economic disparities between the provinces", "the population and developmental needs" and "other legitimate interests of each province".<sup>6</sup> The foundation for primary allocation of financial resources to all levels of government, as well as some form of financial equalisation, was thus laid in the Constitutional Principles and although they were not detailed prescripts, they clearly shaped the constitutional provisions concerning financial matters.<sup>7</sup>

In accordance with economic theory and with due recognition of the socio-economic situation in South Africa, the purpose of financial equalisation is to provide equality in provinces' capacity to provide public services to all the people without having to impose hugely differential taxes and charges at a provincial level as these could

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<sup>4</sup> Schedule 4 of Act 200 of 1993. See *In Re: Certification of the Constitution of the Republic of South Africa*, 1996 1996 10 BCLR 1253 (CC); 1996 4 SA 744 (CC) paras 410 – 442. See discussion under **2 2 1** and **4 2 2**.

<sup>5</sup> See discussion in **Ch 3**.

<sup>6</sup> CP XXVII: "A Financial and Fiscal Commission, in which each province shall be represented, shall recommend equitable fiscal and financial allocations to the provincial and local governments from revenue collected nationally, after taking into account the national interest, economic disparities between the provinces as well as the population and developmental needs, administrative responsibilities and other legitimate interests of each of the provinces."

<sup>7</sup> Ch 14 of the Constitution. See *First Certification Case* para 30; De Villiers *The Constitutional Principles: Content and Significance* in De Villiers (ed) *Birth of a Constitution* (1994) 37 43.

enhance existing disparities.<sup>8</sup> The focus of financial equalisation is on financial capacity and not on actual performance. This resembles the situation in the German system where horizontal equalisation is aimed at a reasonable equalisation of the financial capacity of the *Länder*.<sup>9</sup>

Section 227 (1) of the Constitution stipulates as follows:

“Local government and each province –

- (a) is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it; and
- (b) may receive other allocations from national government revenue, either conditionally or unconditionally.”

The statement in section 227 (1) of the Constitution contains two elements, namely the right of local government and each province to an equitable share of revenue, and secondly, the stipulation that local government and each province must use the equitable share to provide basic services and to perform the functions allocated to it. This is the only indication of the purpose of financial equalisation found in the Constitution. The wording suggests that the equalisation of financial capacity is geared towards specific expenditure obligations such as the provision of basic services. This is a somewhat mechanistic approach. The provision in section 227 (1) falls short of an overarching constitutional aim, such as the improvement of the quality of life for everyone, that would be in line with the basic values of dignity and equality contained in section 1 of the Constitution.

Despite the mechanistic formulation in section 227 (1), financial equalisation should have substantive results such as improved living conditions that will go a long way in addressing the socio-economic needs of South Africa. The allocation of funds for the purpose of equalisation of financial capacity is only one side of a coin. The other side is the ability of provinces and municipalities to utilise these funds for the performance of their functions. If provinces and municipalities underspend their budgets, as is the

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<sup>8</sup> Musgrave *Public Finance* 413; Oates *Fiscal Federalism* (1993) 35 – 38; Mathews *Fiscal equalisation in a federal system* (1970) 1; Mokgoro *Interprovincial Fiscal Equalisation* 286.

<sup>9</sup> Art 107 of the Basic Law. See discussion under **5 3**.

case in many instances during the last few years, it is an indication of their inability to manage their budgets properly or their inability to perform their functions as governments. In these situations the purpose of financial equalisation has not been achieved.

It is evident that the level of services provided by each province and local government and therefore the financial needs of each province and local government, is not static and will change over time. Although the various provinces provide different levels of services, according to their needs and budget priorities, there can be national minimum standards that should apply to all provinces. The existence of such standards will have an effect on a province's budget as this can limit the discretion of provinces to determine their own budget priorities. In concurrent fields, such as education, health and social services, national legislation can lay down national or minimum standards for service delivery, for example, the Norms and Standards for School Funding promulgated in terms of the South African Schools Act, 84 of 1996. In cases of exclusive provincial functional areas such as ambulance services and libraries, national legislation can, in terms of section 44 (2) of the Constitution, be enacted to ensure that minimum standards for service delivery are applicable throughout the country.<sup>10</sup>

The Constitution provides the basic framework for financial equalisation, but this must be complemented by an Act of Parliament that would provide the detail of the actual financial equalisation or division of revenue, as it is termed in the Constitution.<sup>11</sup> Such an Act can only be enacted after the provinces, local government and the Financial and Fiscal Commission have been consulted and a range of policy objectives have been considered.<sup>12</sup> The Constitutional Court said that the importance of these provisions warrants direct consultation with provinces, hence the requirement that such legislation must follow the section 76 (1) legislative

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<sup>10</sup> Currie & De Waal *Constitutional Law* 165 – 169.

<sup>11</sup> Sec 214 of the Constitution.

<sup>12</sup> Sec 214 (2) of the Constitution; Wehner "Fiscal Federalism in South Africa" 2000 *Publius* 47 61.

procedure, in terms of which provinces have a significant say through their participation in the National Council of Provinces.<sup>13</sup>

Unlike the situation in Germany, where local government forms part of the constitutional order of the *Länder* and is treated as such in the financial equalisation process, local government is a distinct sphere of government in South Africa and also participates in the financial equalisation process.<sup>14</sup> Local government in South Africa, consisting of various categories of municipalities, is responsible for the provision of basic services to communities and for the promotion of social and economic development, and is entitled to receive an equitable share of nationally raised revenue to enable it to provide these services and to perform the functions allocated to it.<sup>15</sup> In view of the fact that municipalities in South Africa raise most of their revenue by way of user charges (electricity and water) and property taxes, there is not the same need for financial equalisation, as is the case with provinces.<sup>16</sup> However, the situation is changing due to the restructuring of the provision of electricity services that will have an impact on municipal finances.<sup>17</sup> Many municipalities in South Africa however, have to address dire socio-economic needs with large parts of the population who cannot afford to pay for basic services. With the Western Cape becoming an increasingly popular province to reside in, the migration of mostly poor unemployed people to the province places additional pressure on municipalities and the provincial government to “stretch” their budgets.

Any increase in the equitable share allocation to local government, might mean less available for distribution to the provinces. Although this is an important factor to bear in mind, financial equalisation is primarily aimed at reducing financial disparities between the national and provincial governments (vertical financial equalisation) and between the provinces (horizontal financial equalisation). Local government, in view of its significant own tax base, receives by far the smallest percentage allocation in

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<sup>13</sup> *First Certification Case* para 419.

<sup>14</sup> Art 106 and 107 of the Basic Law; sec 40, 214 and 227 of the Constitution. See discussion under **5 4 1** regarding the constitutional incorporation of the German municipalities under the *Länder*, and the implications thereof in the financial equalisation process.

<sup>15</sup> Sec 152 (1) and 227 (1) of the Constitution; Currie & De Waal *Constitutional Law* 217 – 218.

<sup>16</sup> Momoniat *Fiscal decentralisation* 5.

<sup>17</sup> See discussion under **4 3 1**.

terms of the equitable division of revenue.<sup>18</sup> The discussion in this Chapter will primarily focus on the financial equalisation between the national and provincial governments and between the provinces.

### **6 3 The financial equalisation process**

The Constitution determines a financial equalisation process in terms of which all revenue collected nationally must be distributed between the various spheres of government.<sup>19</sup> This must be done in an equitable way with the purpose of enabling provinces and local government to provide basic services and perform the functions allocated to them. Although the term "financial equalisation" is not used in the Constitution, it is evident that the distribution of nationally raised revenue to the three spheres of government is a financial equalisation exercise. In view of the fact that the major sources of tax revenue are located at the national sphere of government, some form of financial equalisation had to be provided for in the Constitution. Sections 214 and 227 of the Constitution provide the framework for the financial equalisation process to take place. The pool of revenue that forms the source for financial equalisation is the revenue raised nationally and thus per definition excludes revenue raised by the provinces and municipalities. Furthermore, the Constitution explicitly excludes own revenue raised by provinces and municipalities from the financial equalisation process and states that it may in fact not be deducted from the equitable share of a province or municipality or from any other allocations from the national government to them.<sup>20</sup>

Section 214 (1) stipulates a financial equalisation process consisting of three elements, namely:

- (i) A vertical financial equalisation, that is an equitable division of nationally raised revenue between the national, provincial and local spheres of government;
- (ii) A horizontal financial equalisation, that is an equitable division of the provinces' share of that revenue among the nine provinces; and

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<sup>18</sup> See Table 6 2.

<sup>19</sup> *First Certification Case* para 281 - 284.

<sup>20</sup> Sec 227 (2) of the Constitution.



- (iii) Additional allocations from the national government share of that revenue to provinces, local government or municipalities.<sup>21</sup>

This financial equalisation process must be dealt with in detail in an Act of Parliament that has to comply with the requirements stipulated in section 214 (2) of the Constitution. One way of giving effect to this constitutional requirement is to have an Act that stipulates the detail of the financial equalisation process and which contains a formula that takes into account the various considerations contained in section 214 (2). The Act must be operative for an agreed number of years.<sup>22</sup> The idea of a law containing a rigid formula did not find support with the National Treasury, who is responsible for this legislation, and it has therefore been decided to use a different approach, namely, an annual Act of Parliament, the Division of Revenue Act, that provides for the actual equitable division of revenue.<sup>23</sup> The Division of Revenue Act is the result of a cooperative process involving the three spheres of government and is only partially based on a formula used to determine the equitable shares of individual provinces. This Act operates in conjunction with the Intergovernmental Fiscal Relations Act, 97 of 1997, that stipulates the process of giving effect to section 214 of the Constitution.

The Intergovernmental Fiscal Relations Act, 1997, makes it clear that the FFC, as an independent and impartial constitutional institution, has an important role to play in making recommendations to the nine provincial legislatures, both houses of Parliament and the national Minister of Finance regarding the actual division of revenue among the three spheres of government. In making its recommendations the FFC must take into account the matters listed in section 214 (2) of the Constitution.

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<sup>21</sup> Sec 214 (1): "An Act of Parliament must provide for –

- (a) the equitable division of revenue raised nationally among the national, provincial and local spheres of government;
- (b) the determination of each province's equitable share of the provincial share of that revenue; and
- (c) any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations may be made."

<sup>22</sup> This approach is for example taken in Belgium where a detailed Act of Parliament makes provision for the division of taxes and revenue to the regional governments and this Act is then operative for ten years. It has a built in adjustment for inflation over the duration of the Act. See Brand "The South African Constitution - three crucial issues for future development" in 1998 (2) *Stell LR* 182 190.

<sup>23</sup> Momoniat *Fiscal Decentralisation* 9.

This requires a careful balancing act to take into account diverse issues such as "the needs and interests of the national government", "the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them" and "the fiscal capacity and efficiency of the provinces and municipalities". The Minister of Finance must consult the nine provincial governments, organised local government and the FFC before the actual division of revenue is done and provided to Parliament in the form of the Division of Revenue Bill.<sup>24</sup> This consultation process takes place in the Budget Council, the Budget Forum and an extended Cabinet meeting to which the nine Premiers are invited, and where the final allocation to the three spheres of government is decided.<sup>25</sup> The actual division of revenue is effected by the Minister of Finance and the officials of the National Treasury, taking into account the recommendations of the FFC and the input of the provinces and organised local government.

Although there is some bargaining within the Budget Council, it is evident from the actual process that the Minister of Finance has a strong influence in the final division of revenue between the three spheres of government. He who pays the piper calls the tune. It is the expressed view of the National Treasury that the division of revenue is based on a political judgement by Cabinet based on the information generated through a consultative process with the FFC, the provinces and local government.<sup>26</sup> The dominance of the centre in this process is not surprising given the current political context where the ANC is in the majority in all three spheres of government. Contrary to the situation in Germany, there is no real opposition or competition between the provinces and the national government. The South African system has been tested in only one political scenario. However if say five of the nine provinces were governed by political parties other than the majority party in the national government, the division of revenue process could result in more intense debates and this could possibly lead to compromises between the "provincial" view and the view of the National Treasury. It is arguable whether such a scenario would result in a

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<sup>24</sup> Sec 10 of the Fiscal Intergovernmental Relations Act, 97 of 1997. See Wehner "Does South Africa still need the Financial and Fiscal Commission?" *Budget Brief* No. 71 (July 2001); Ajam *Fiscal decentralisation in SA* 69 et seq.

<sup>25</sup> Momoniat *Fiscal Decentralisation* 9.

<sup>26</sup> National Treasury *Intergovernmental Fiscal Review 2000* A.7; Murray & Simeon 2000 (15) SAPR/PL 485; Dept. of Finance *Budget Review 1999* (Feb. 1999) 258.

more efficient financial equalisation system when compared to the current situation. It is, however, evident that the good cooperation between National Treasury and its provincial counterparts (“Team Finance”) contributes to the effective functioning of the financial equalisation system in the current political context.

The Constitution gives high status and an important role to the FFC in financial intergovernmental relations. It must be an independent institution that gives advice and recommendations regarding the equitable division of the available pool of funds in the country. It would, however, seem that the profile of the FFC has diminished over time and that its recommendations are often ignored. The FFC itself indicated in 2000 that it experienced problems related to the way government responds, or fail to respond, to its inputs.<sup>27</sup> At the FFC’s tenth anniversary conference in 2004 the Minister of Finance thanked the FFC for the crucial role it played in the creation of the architecture of financial intergovernmental relations in South Africa, but also expressed concern about the “formulaic approach” of the FFC regarding the division of financial resources and argued for more policy room for government.<sup>28</sup> These comments confirm the current situation where the National Treasury would like to dictate the division of revenue (and to a large degree does) based on policy considerations. The FFC however must guide the division of revenue process from an independent perspective, that includes to a large degree a “formulaic approach”, that could depoliticize the debates about the division of revenue. It remains to be seen how this relationship between the FFC and the National Treasury will develop.

### **6 3 1 Vertical financial equalisation**

There is a fiscal imbalance between the expenditure obligations of provinces and their own sources of revenue, referred to as a fiscal gap.<sup>29</sup> Vertical financial equalisation can be defined as the process of revenue sharing through which this fiscal gap is

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<sup>27</sup> FFC *Annual Report 1998 – 1999* (2000) 33; Wehner “Does South Africa still need the Financial and Fiscal Commission?” in *Budget Brief* No. 71 (2001) 1 – 4.

<sup>28</sup> Min Trevor Manuel, Minister of Finance *Address to the FFC 10<sup>th</sup> Anniversary Conference* (11 August 2004) 6.

<sup>29</sup> Visser & Erasmus *Management of Public Finance* 267; Ajam *Fiscal decentralisation in SA* 57; Van Zyl “Financing the provinces in South Africa” *Occasional Paper No. 3* (November 1997) 1.

closed. The first step in the financial equalisation process or division of revenue, as it is labelled in the Constitution, is a vertical division of the nationally raised revenue between the national, provincial and local spheres of government.<sup>30</sup> This division of revenue is applied to a pool of revenue that includes all the major taxes, namely personal and corporate income tax, value-added tax and the fuel levy. In terms of section 155 (1) of the 1993 Constitution, the provinces were entitled to an equitable share that consisted of percentages of a specified list of taxes, namely personal income tax, value-added tax, the fuel levy and any transfer duty on the sale or transfer of property. The current provision in section 214 of the Constitution does not list the taxes included in the financial equalisation process, but stipulates an all-inclusive pool of nationally raised revenue. This increases the potential scope of financial equalisation since the pool of revenue utilised for this process is larger than what the position was under the 1993 Constitution. It is an important conceptual change from the allocation of equitable shares of a limited number of taxes to the nine provinces, to a pool of revenue to which the three spheres of government all have a right to claim an equitable share.

During the period from 1994 to 1997 provincial budgets were in fact the sum total of various functional allocations determined at national government level. The Department of Finance was responsible for the transfer of the consolidated allocations per functional area to the individual provinces. The *de facto* situation of financial intergovernmental relations in South Africa during that period was a reflection of the transitional phase in which South Africa's constitutional development was at the time. It was not only a question of getting the nine provinces and local government properly established and functioning, but it also included the complex situation of integrating the existing infrastructure and personnel of all the previous administrations at provincial level. This included integrating the previous "black homelands" into the new provincial administrations. This mammoth task required the involvement of the national Department of Finance to guide and assist the provinces to become fully functional and included the development of financial management and budgeting

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<sup>30</sup> Sec 214 (1) of the Constitution.

skills. The situation changed in 1997 when the new financial equalisation provisions took effect and provinces had to draw up their own budgets for the first time.<sup>31</sup>

The vertical financial equalisation is based on the division of functions in terms of the Constitution and the basic premise is that funds should follow function. In terms of the constitutional allocation of functions to the various spheres of government, the delivery of major public services such as health, education (other than tertiary education) and welfare is the responsibility of the provinces. This implies that a substantial percentage of the pool of revenue to be distributed should be allocated to the provinces. Before the actual division takes place, provision is made for debt service costs and a contingency reserve kept by the National Treasury.<sup>32</sup> It is questionable why there is a “top slicing” to deduct debt service costs from the pool of revenue to be distributed, while almost all debt is incurred at national level and the servicing thereof should thus be included in the national share of revenue.

The National Treasury has to acknowledge the constitutional requirement that provinces and local government should be financially enabled through the equitable division of revenue to provide basic services and perform their own constitutionally allocated functions. In its *Intergovernmental Fiscal Review 2000* the National Treasury confirmed that the provinces have a constitutional obligation to provide the major social functions of school education, health and welfare services. Health services include the provision of primary health care and regional, specialised and academic hospitals. Local government is responsible for the provision of basic household infrastructure services such as municipal roads and street lighting, (tax-funded services) and the provision of household electricity and water (primarily funded by user charges).<sup>33</sup> This practical application of the constitutional division of obligations as well as the requirements of sections 214 (2) and 227 (1) of the Constitution are given effect in the first step in the financial equalisation process, namely the vertical division of revenue. In its submission to Parliament, in the form

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<sup>31</sup> Wehner *Fiscal Federalism in South Africa* (1999) 46.

<sup>32</sup> This is referred to as “top slicing”. In practice it means that the pool of revenue is reduced by the cost of servicing the national debt and the amount set aside for a contingency reserve. Only after this top slicing took place can the pool of revenue be divided between the three spheres of government. See Momoniat *Fiscal decentralisation* 9.

<sup>33</sup> National Treasury *Intergovernmental Fiscal Review 2000* 5 – 6.

of the annual *Budget Review*, National Treasury explains in detail how the various factors, or policy objectives in section 214 (2) of the Constitution, are taken into account when determining the equitable division of revenue.<sup>34</sup>

In 2001 the FFC put the process of determining the equitable shares of the three spheres of government under the spotlight and as a result, it was suggested that a research study be undertaken to provide clear definitions of basic service obligations and other constitutional obligations.<sup>35</sup> In its recommendations the FFC proposed that the equitable division of nationally raised revenue, after the deduction of debt servicing and a contingency reserve, should include a priority claim for meeting constitutionally mandated basic service obligations, before the needs for the management and administration of the various institutions within each sphere of government and the funding of other constitutional functions, be addressed. Such research can assist in providing clarity of definitions and perhaps also in developing objective criteria to determine the actual vertical split. This would limit the potential for political manipulation, but does not change the basic elements of the financial equalisation process, it only assists in refining it.

The debate continues from another angle. Various provinces and municipalities have not succeeded in properly fulfilling their constitutional mandates as a result of their inability to spend their budgets. Expectations were raised in 1994 that the newly created provinces would develop rapidly into “mature” institutions of government that can effectively perform all the functions allocated to them. After ten years of democracy the expectations are still there but the flaws in the system are becoming a serious concern. In critical areas such as education, health and housing, there continues to be a substantial underspending in many provinces, which implies that not enough houses are built for the poor, not enough school classrooms are available and that people have to walk long distances to reach the nearest medical clinic. It is thus not enough that the equitable division of revenue should result in sufficient funding to provinces, but it is implied that provinces must utilise their budgets fully and effectively.

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<sup>34</sup> This is done in Annexure E: Explanatory memorandum to the division of revenue. See for example National Treasury *Budget Review 2003* 239 et seq.

<sup>35</sup> FFC *Submission – Division of Revenue 2002 – 2003* (June 2001) 6.

### 6 3 2 Horizontal financial equalisation

The horizontal division of revenue is an important component of the financial equalisation process in view of its potential to reduce disparities between provinces. The actual demand for basic services, which is based on the demographic and economic profiles of the individual provinces, is a key indicator that guides the horizontal division of revenue.<sup>36</sup> Poverty and lack of infrastructure development in particular provinces, for example, KwaZulu-Natal, Limpopo and the Eastern Cape, contribute to a disparate situation and leads to an increase in the allocation to these provinces. The division of revenue amongst the nine provinces or horizontal financial equalisation is formula driven and takes into account the policy objectives or factors listed in section 214 (2) of the Constitution. The allocation of the horizontal division among the provinces, as reflected in the annual Division of Revenue Act, is not appropriated in the national budget, but only in the individual provincial budgets, since it is regarded as a direct charge against the national revenue fund.<sup>37</sup>

In its *Framework Document for Intergovernmental Fiscal Relations in South Africa* the FFC has analysed the various economic concerns, constitutional requirements and policy considerations regarding intergovernmental fiscal relations and came to the conclusion that the development of a formula that contains objective elements, is necessary to provide more certainty regarding revenue allocations and to avoid any arbitrary allocations.<sup>38</sup> Based on the *Framework Document* the FFC recommended, in 1996, a formula for the horizontal division of revenue that was applied from the following financial year, namely 1997/98.<sup>39</sup> This formula was phased in over a period of five years. An allocation formula, according to the FFC, is designed to achieve an equitable division of public resources between the three spheres of government, and more specifically to achieve an equitable division of revenue

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<sup>36</sup> Min. of Finance *Medium Term Budget Policy Statement 1997* (2 December 1997) 41.

<sup>37</sup> Sec 213 (3) of the Constitution; Momoniat *Fiscal decentralisation* 11.

<sup>38</sup> FFC *Intergovernmental Fiscal Relations* 11.

<sup>39</sup> FFC *The Financial and Fiscal Commission's Recommendations for the Allocation of Financial Resources to the National and Provincial Governments for the 1997/98 Financial Year (Recommendations for 1997/98)* (May 1996) 7; Van Zyl *Occasional Paper No 3* (Nov 1997) 8.

between the provinces. Using a formula reduces the risk of political manipulation and arbitrary decision making, and it introduces objective criteria in terms of which the actual allocation is made. In 1997 a new medium term expenditure framework (MTEF), in terms of which budget planning would be done on a three-year basis, was also introduced.<sup>40</sup> The MTEF coupled with the formula for the horizontal division of revenue provide certainty of revenue, which is important for provincial planning and budgeting.

The FFC formula consists of the following elements:

- S = a minimum national standards grant, which is aimed at supplying provinces with sufficient funds to provide primary and secondary education and primary health care;
- m = a spillover grant to provide funding for the services that have a spillover effect, such as the academic hospitals in the Western Cape, Gauteng, KwaZulu-Natal and Free State;
- T = a fiscal capacity equalisation grant, which is aimed at ensuring an equitable provincial taxing capacity and to encourage accountability;
- I = an institutional grant to provide funds to each province to finance its basic administration as required by the Constitution; and
- B = a basic grant to enable provinces to establish and maintain the institutions necessary to fulfil its constitutional obligations according to provincial priorities.

The provincial formula can be expressed as follows, namely:

$$P \text{ (provincial allocation)} = S + m + T + I + B.^{41}$$

This formula is population driven and therefore depends on accurate demographic statistics (normally provided by the national census) or population estimates for the education, health and social security components and the basic share. The minimum national standards grant consists of two elements, namely education and primary health. Population figures are important in both cases. The determination of the

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<sup>40</sup> Min. of Finance *Budget Policy Statement 1997* 4.

<sup>41</sup> FFC *Recommendations for 1997/98* ii, 7; Ajam *Fiscal decentralisation in SA* 70 – 74.



minimum standards grant in a province's equitable share is dependent on the number of people eligible for these basic services per province, the average cost thereof and the national minimum standards for example a teacher: learner ratio of 1:38.<sup>42</sup>

The FFC proposed the fiscal capacity equalisation grant in order to supplement provincial revenue where the fiscal or taxing capacity is below the national average, thus promoting financial equalisation. Since this formula was first introduced for the 1997/98 financial year the FFC has recommended continuously that provinces' own revenue sources must be augmented by the introduction of a surcharge on personal income tax.<sup>43</sup> This proposal has not yet been supported by the Minister of Finance. The fiscal equalisation grant fills the gap created by a lack of significant provincial taxes.

The FFC's recommendations must be taken into account in the process of determining the equitable division of revenue, but it need not be accepted.<sup>44</sup> The Minister of Finance only partially accepted the FFC recommendations for the 1997/98 financial year, the first year of implementation of this formula. The final formula that has been adopted consists of the following seven components, each has a different weighting. This formula is still utilised:<sup>45</sup>

- An education component, which is determined by the number of actual learners enrolled and the average size of the school-age population. The provision of primary and secondary school education and further education and training colleges is the responsibility of provinces, and due to previous different and discriminatory school systems for the various population groups, forms a focus point for financial equalisation aims. Provinces must budget for the provision of education and determine their spending priorities giving due recognition to the norms and standards for funding of schools as determined by the national government.<sup>46</sup>

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<sup>42</sup> FFC *Recommendations for 1997/98* 7 – 11, Ajam *Fiscal decentralisation in SA* 70 – 74.

<sup>43</sup> FFC *Recommendations for 1997/98* 14.

<sup>44</sup> Sec 214 (2) of the Constitution.

<sup>45</sup> Min. of Finance *Budget Policy Statement 1997* 41; Momoniat *Fiscal decentralisation* 11; Wehner *Fiscal Federalism in South Africa* 83 – 86.

<sup>46</sup> Sec 12 (provision of public schools), 35 (norms and standards for public schools) and 36 (responsibility of governing body) of the South African Schools Act, 84 of 1996 read with the Norms and Standards for School Funding promulgated on 12 October 1998 by General Notice 2362

- A health component, that provides funding for the responsibility of provinces to deliver primary and secondary health services. Although all citizens are eligible for health services provided by the state, this component focuses on the section of the population without private medical aid or medical insurance.
- A welfare component, which addresses the provinces' responsibility to provide social security grants to various categories of people, such as the elderly, entitled to such grants.
- A basic component, which is based on the province's share of the total population with an additional weighting in favour of rural communities to address poverty. This rural weighting in the basic component fell away when the backlog component was introduced in the 1999/00 financial year.
- An economic output component. This component has a dual purpose, namely to compensate provinces for a lack of own provincial taxes, and to reflect the distribution of economic activity across the provinces. The gross geographic product (GGP) figures are used as an indicator of economic activity per province.
- An institutional component, that is aimed at covering the cost of running each provincial government. This is equally divided between the nine provinces.
- A backlog component was added in the 1999/00 financial year in order to address the backlog in infrastructure development. It consists of three elements, namely, capital needs relating to schools, hospital facilities and rural infrastructure.<sup>47</sup>

The above elements of the provincial equitable share do not serve as directives to provinces on how they should allocate their resources, but rather reflect estimates of the demand for basic services. Provinces must budget for all their functions and prioritise their spending needs within their overall resource constraints. The

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(Government Gazette 19347). In *Ex Parte Speaker of the National Assembly: In re Dispute concerning the constitutionality of certain provisions of the National Education Policy Bill 83 of 1995* 1996 3 SA 289 (CC) para 27 the Court ruled that in view of the fact that education is a concurrent legislative function, consultation and cooperation between national and provincial governments in the field of education, as was envisaged by the Bill, is consistent with the constitutional arrangements. Determination of national norms for provision of school education by provinces clearly requires consultation and cooperation between the two spheres of government.

<sup>47</sup> Dept of Finance *Intergovernmental Fiscal Review 1999* (Sept 1999) 2.6; Wehner *Fiscal Federalism in South Africa* 85.

provincial budget process takes place within the MTEF applicable throughout the country. This implies that provincial departments must individually plan and budget for a three year period and the provincial treasuries must compile the provincial budget in cooperation with the various provincial departments.

The FFC proposed in 1996, and it was so adopted, that the formula for the division of revenue should be phased in over five years. It was done to avoid serious disruptions in provincial allocations in view of differences between the initial allocation to provinces and the target shares. Due to the equalisation effect of the horizontal division of revenue, it is in particular the so-called richer provinces, namely Gauteng and Western Cape, that stand to lose more over the short term if the formula was not phased in. The phase-in period was changed in 1998 when new census data was incorporated into the financial equalisation process. The new target date for the five-year phase-in period was agreed to be the 2003/04 financial year and the formula is now fully implemented.<sup>48</sup> The following table shows the horizontal division of revenue for the 2002/03 financial year, with reference to each component of the formula.

**Table 6 1      Determination of equitable share of each province<sup>49</sup>**

Province	Education	Health	Welfare	Basic Share	Economic Activity	Institutional	Backlog	Target Shares
Weighting	41,0	19,0	18,0	7,0	7,0	5,0	3,0	100,0%
Eastern Cape	18,4	17,0	19,6	15,5	6,5	11,1	20,6	17,0
Free State	6,3	6,5	7,1	6,5	5,3	11,1	5,7	6,6
Gauteng	12,6	14,7	13,9	18,1	41,6	11,1	5,1	15,4
KwaZulu-Natal	22,0	21,7	19,6	20,7	17,0	11,1	22,9	20,6
Limpopo	15,4	13,3	13,7	12,1	3,0	11,1	22,9	13,6
Mpumalanga	7,3	7,2	6,5	6,9	4,9	11,1	8,5	7,2
Northern Cape	1,9	2,0	2,2	2,1	1,7	11,1	1,3	2,4
North West	8,0	8,6	8,7	8,3	5,7	11,1	9,4	8,3
Western Cape	8,0	8,9	8,8	9,7	14,4	11,1	3,7	8,9

<sup>48</sup> National Treasury *Budget Review 2003* 260; National Treasury *Intergovernmental Fiscal Review 2000* A.10.

<sup>49</sup> National Treasury *Budget Review 2003* 260.

<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
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Note: 1. The target shares indicate the percentage division of revenue between the provinces aimed at in the 2003/04 financial year.  
2. The weighting percentages indicate the relative weight attached to each component of the formula.

The incorporation of the 1996 census figures in the 1998/99 division of revenue was cause for some controversy because of the differences between the preliminary figures, that were used in the 1998/99 provincial allocations, and the final census figures that were used since then, and the impact that these figures have on the actual division of revenue. While provinces such as the Northern Province (Limpopo), Eastern Cape and KwaZulu-Natal gained from the adjusted census figures, the Western Cape lost significantly. The Western Cape was the only province whose population figure decreased in the adjustment process, and this has consequentially caused a reduced percentage share of the total provincial equitable share.<sup>50</sup>

The horizontal division of revenue between the nine provinces recognises the different demographic and economic profiles of the various provinces and therefore also the disparities in socio-economic development. The equitable share formula is aimed at financial equalisation or redistribution of financial resources, in order to promote a better quality of life for all South Africans. In view of its aim of financial equalisation, the equitable share allocation results in a higher per capita allocation to the poorer rural provinces.<sup>51</sup> The equitable share formula is a significant policy instrument in the hands of the national government. It can influence provincial spending patterns through the stipulation of national standards in areas such as primary and secondary school education and primary health care, or by changing the relative weight of the different components of the equitable share formula. The autonomy of provinces to determine their own spending priorities in order to meet the demand for more and better quality public services is however recognised by the

<sup>50</sup> The preliminary population figure for the Western Cape was 4,1m and it was reduced to 3,9 m in the final census results. This was questioned by the Western Cape Provincial Government, but without any avail because the official figures were not changed. See Van Zyl *Occasional Paper No 3* (Nov 1997)12.

<sup>51</sup> National Treasury *Budget Review 2001* 147.

national government.<sup>52</sup> Within all the provinces there are differences in socio-economic conditions of the different communities. Even in the so-called rich provinces pockets of poverty exist. Provincial policies and the setting of provincial spending priorities are therefore just as important as the setting of national standards and can have redistributive effects within individual provinces.

The FFC proposed, in 2000, a change in the formula for the horizontal division of revenue from a formula based on the economic and demographic profiles of the provinces to a costed norms based formula.<sup>53</sup> According to the FFC the costed norms approach to the formula is a way of calculating the financial resources necessary for the provision of basic social service levels taking into account norms and standards determined nationally.<sup>54</sup> In other words, there must first be an estimate of the costs for the provision of a basket of basic services (education, welfare and health) that must be provided by the provinces at least at a minimum level. These minimum norms and standards are nationally determined. Horizontal division of revenue should thus be done on the basis of costed norms. The purpose of this approach, according to the FFC, is to ensure that each province has sufficient funds to provide all their inhabitants with constitutionally mandated basic social services at a nationally determined standard.<sup>55</sup>

This approach did not find support with the National Treasury nor with the Budget Council due to the lack of sufficient data necessary to cost the norms and standards and the lack of clear norms and standards in certain areas.<sup>56</sup> The FFC itself acknowledged that this was a shortcoming in its model, but still recommended it with a view to ensure a more objective approach to the calculation of the formula. An

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<sup>52</sup> National Treasury *Intergovernmental Fiscal Review 2003* 14; National Treasury *Intergovernmental Fiscal Review 2000* A.2

<sup>53</sup> FFC *Recommendations 2001 – 2004 MTEF Cycle* (May 2000) 7 – 11.

<sup>54</sup> FFC *Recommendations 2001 – 2004* 7.

<sup>55</sup> FFC *Recommendations 2001 – 2004* 7.

<sup>56</sup> National Treasury *Budget Review 2001* 233.

additional criticism by the National Treasury was that such a “bottom up” approach would neglect the role of political judgement required in setting budget priorities.<sup>57</sup>

In later proposals the FFC has again recommended the costed norms approach, albeit in a somewhat refined form. It, for example, suggested that the education element must be based on the cost per learner of providing basic education to four target groups, namely those above or below the poverty line in rural and urban schools respectively.<sup>58</sup> These recommendations were made in the absence of sufficient reliable data and were also not quantified. It is thus difficult to evaluate what the direct effect of this costed norms approach would be on the actual financial equalisation process. The National Treasury has responded in *Budget Review 2002* that a “formula-based approach” for the division of revenue as suggested by the FFC is impracticable for various reasons, for example the lack of concise definitions of constitutionally mandated basic services, the absence of objectively determined norms and standards for basic services and the unavailability of data necessary to implement such an approach.<sup>59</sup> The National Treasury is, however, in favour of a regular review of the current formula and has commented in the *Budget Review 2003* that it will undertake a comprehensive and fundamental review of the equitable share formula and all other allocations to provinces and local government. This it will do in cooperation with the FFC.<sup>60</sup> The review was still in progress when the 2004 division of revenue was done and will only be completed in time for the 2005 budget.<sup>61</sup>

The attempts of the FFC to find an alternative or improved formula for the equitable division of revenue, suggest that there should be more emphasis on objective elements in the financial equalisation process and a lesser role for political decision-making by the National Treasury. This obviously does not find favour by the National Treasury, which dominates financial intergovernmental relations in South Africa.<sup>62</sup> The

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<sup>57</sup> National Treasury *Budget Review 2001* 235

<sup>58</sup> FFC *Submission – Division of Revenue 2002 – 2003* (June 2001) 18.

<sup>59</sup> National Treasury *Budget Review 2002* 241.

<sup>60</sup> National Treasury *Budget Review 2003* 253.

<sup>61</sup> National Treasury *Budget Review 2004* 258.

<sup>62</sup> Murray & Simeon 2000 (15) *SAPR/PL* 498.

principles of co-operative government require co-operation between all the spheres of government and recognition of each sphere's constitutional integrity. Although nation-building dominated the formulation of the financial equalisation provisions in the Constitution and the ensuing legislation, it is perhaps time that in line with the FFC's attempts to improve the financial equalisation process a more balanced approach should be developed where provinces should play a more significant role in the decision-making process. There should perhaps also be a greater emphasis on objective elements in the financial equalisation process. In this regard the German experience provides valuable lessons for consideration.

### **6 3 3 Additional allocations**

The third stage of the financial equalisation process in terms of section 214 (1) (c) of the Constitution, is the determination of additional allocations from the national government's equitable share of nationally raised revenue to provinces and local government or municipalities where these allocations are reflected in the annual Division of Revenue Act. These allocations are in addition to the equitable share allocations to provinces and local government and are in the form of conditional grants. In 2003 the equitable share accounted for approximately 90 percent of transfers to provinces while the remaining 10 percent consisted of conditional grants.<sup>63</sup> They are determined by the national government and are aimed at funding specific priority programmes. This provides an important policy instrument for the national government, that can direct the spending of a grant by setting national standards and adding further conditions to it. Through these conditional grants the national government can ensure that provinces deliver services within the concurrent functional areas at a stipulated national standard, failing which the national government can intervene in various ways, including the stopping of transfer of funds to the particular province.<sup>64</sup> These grants are asymmetric in nature and address interjurisdictional spillovers, for example to provide targeted funding for research and

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<sup>63</sup> National Treasury *Budget Review 2003* 160.

<sup>64</sup> National Treasury *Intergovernmental Fiscal Review 2000* 58. Intervention mechanisms, which are available as a last resort mechanism in case of a financial (or other) crisis, are provided in the Constitution in sections 100, 139 and 216.

training at the academic hospitals in Gauteng and Western Cape where most of South Africa's medical students are trained.

According to the National Treasury conditional grants have an important role to play in intergovernmental financial relations and are intended to:

- Make provision for national priorities in provincial budgets;
- Promote national norms and standards;
- Provide funding to provinces that deliver specialised services and services which have a cross-border spillover effect; and
- Support capacity building within provincial government.<sup>65</sup>

Since the introduction of conditional grants in 1998 a range of grants with a variety of conditions attached have been provided to provinces and local government. The following are examples of these grants:

- Funding for the Consolidated Municipal Infrastructure Programme, where the provinces acted as agents for the municipalities in the development of infrastructure in local communities;
- Funding for professional training and research in health to all provinces, but substantially higher allocations were made to the provinces with academic hospitals, such as Gauteng, Western Cape and KwaZulu-Natal;
- An HIV/AIDS Health Grant to all provinces to enable the health sector to “develop an effective response to the HIV/AIDS epidemic”;<sup>66</sup> and
- Funding for special Presidential projects on urban renewal, where provinces would act as agents for the national government.

Conditional grants are budgeted for in the budgets of the respective national departments, but spent by the provinces. The national departments of Health, Housing and the National Treasury (provincial infrastructure grant) administer most of the additional grants to provinces.<sup>67</sup> The National Treasury rationalised the diverse range of conditional grants in 2001 in order to enhance administrative efficiency and

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<sup>65</sup> National Treasury *Budget Review 2001* 149.

<sup>66</sup> Schedule 5 Division of Revenue Act, 7 of 2003.

<sup>67</sup> National Treasury *Budget Review 2003* 161 – 165.



accountability.<sup>68</sup> In addition, the Minister of Finance introduced new policy priorities relating to the additional allocations; these include a focus on the child support grant, poverty alleviation programmes and infrastructure maintenance and development to stimulate investment and economic growth.<sup>69</sup> The effect of the additional allocations to provinces and local government are indicated in **Table 6 2** that sets out the division of revenue between the three spheres of government for the 2000/01, 2001/02, 2002/03, 2003/04 and 2004/05 financial years. The figures for the 2004/05 financial year are indicative figures and form part of the Medium Term Expenditure Framework (MTEF).

It is evident from **Table 6 2** that conditional grants form a substantial part of the total allocation to local government, while in the case of provinces additional allocations, in the last stage of the financial equalisation process, form a relatively small part of their total allocation. It is evident that during the period 2000 – 2005 it was planned that there should be a steady increase in the allocations to provincial and local governments to support improved service delivery.

**Table 6 2 Division of revenue between the spheres of government<sup>70</sup>**

<b>R million</b>	<b>2000/01 Outcome</b>	<b>2001/02 Outcome</b>	<b>2002/03 Revised estimates</b>	<b>2003/04 Medium-term estimates</b>	<b>2004/05</b>
National allocation	73 142	87 709	98 853	108 983	117 549
Provincial allocation	108 904	121 099	136 919	158 995	175 468
Equitable share	98 398	107 460	123 457	142 386	155 313
Conditional grants	10 506	13 638	13 462	16 609	20 155
Local government					
Allocation	5 576	6 516	8 801	12 001	13 249
Equitable share	2 315	2 607	3 964	6 343	7 078
Conditional grants	3 261	3 909	4 837	5 658	6 171
<b>Allocated expenditure</b>	<b>187 621</b>	<b>215 324</b>	<b>244 573</b>	<b>279 979</b>	<b>306 266</b>
<b>Percentage of shared total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
National share	39,0%	40,7%	40,4%	38,9%	38,4%
Provincial share	58,0%	56,2%	56,0%	56,8%	57,3%
Local government share	3,0%	3,0%	3,6%	4,3%	4,3%

Note: The national government share excludes the additional allocations (conditional grants) made to provincial and local governments, since it is included at the appropriate sphere of government where it is spent.

<sup>68</sup> National Treasury *Budget Review 2001* 149.

<sup>69</sup> National Treasury *Budget Review 2001* 240.

<sup>70</sup> National Treasury *Intergovernmental Fiscal Review 2003* 5.

The provision of additional allocations to provinces, local government and municipalities has not been without problems. Some of the conditional grants were poorly designed and contributed to a fragmentation of the budget process. National Treasury has addressed this problem by rationalisation of the variety of grants to have a comprehensive set of dedicated conditional grants within various functional areas.<sup>71</sup> While provinces receive most of their funding by way of the equitable share and can set their own budget priorities, the conditional grants are sometimes used by national departments to direct spending in provinces and, in a way, override provincial governments' discretion to determine their own priorities.<sup>72</sup> Conditional grants can be beneficial to both the national government and the provincial and local governments by enhancing certain policy objectives while addressing the need for additional funding at the lower levels of governments.

One of the biggest challenges that faces government in South Africa is the HIV/AIDS<sup>73</sup> pandemic, that poses a growing threat to the economy while making high demands on national and provincial government budgets.<sup>74</sup> HIV/AIDS is a major health problem and requires specific funding for treatment facilities, medicine and counselling of patients throughout the country. Since most health services are delivered by provinces, the dedicated funding to combat HIV/AIDS must be included in the budgets of the provincial health departments. The fight against HIV/AIDS is, however, not only a health issue as other functional areas such as education and welfare also play a significant role and must therefore also have appropriate budgets and action plans in place. In view of the fact that provinces are responsible for the delivery of health, welfare and school education services to the public, it is clear that the fight against HIV/AIDS places a heavy additional burden on provincial budgets. The national government will obviously also have to budget for combating HIV/AIDS, but the primary delivery of services involved in fighting the pandemic

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<sup>71</sup> National Treasury *Budget Review 2004* 263 – 268.

<sup>72</sup> Momoniat *Fiscal decentralisation* 11.

<sup>73</sup> This is the generally accepted term for the human immunodeficiency virus that lead to the acquired immune deficiency syndrome.

<sup>74</sup> *Min of Health and Others v Treatment Action Campaign and Others (No 2)* 2002 5 SA 721 (CC) para 93; Van Wyk "The enforcement of the right of access to health care in the context of HIV/AIDS and its impact on the separation of powers" 2003 (66) *THRHR* 389 389.

rests with provinces. National Treasury indicated in the *Budget Review 2002* that there would be an increased allocation to provinces in the fields of education, health and welfare to complement the provincial own allocations in these areas to combat HIV/AIDS.<sup>75</sup> This was reflected in the Division of Revenue Act, 5 of 2002, as conditional grants dedicated to HIV/AIDS programmes in education, health and welfare.<sup>76</sup> In 2003 and 2004 there was again an increase in the specific grants to provinces for combating HIV/AIDS.

It is clear that from a financial intergovernmental relations perspective the approach is that provinces should budget in a manner that would enable them to effectively address HIV/AIDS. There should, for example, be priority programs in health, education and welfare dealing with HIV/AIDS and funded by the provinces from their equitable share allocation. Dedicated funding in the form of conditional grants can also be provided to provinces as additional allocations from the national government share of revenue.

The example regarding HIV/AIDS illustrates the fact that conditional grants can be utilised effectively to make sure that national priorities get properly reflected in provincial budgets.

## **6 4 A comparative analysis**

The purpose of this section is to compare key issues relating to financial equalisation in Germany and South Africa, with a view to learning from the German experience and to make recommendations for the improvement of the relatively new system in South Africa. Amongst the various elements of the financial intergovernmental relations systems in both Germany and South Africa, one element is quite central, namely financial equalisation. This is because of its important socio-economic effects. In view of the important role it plays in both the German and the South African constitutional systems, a comparison of financial equalisation based on the following elements follows:

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<sup>75</sup> National Treasury *Budget Review 2002* 15, 141.

<sup>76</sup> Schedule 4 of Act 5 of 2002.

- Purpose of financial equalisation
- Constitutional accommodation
- Role of additional legislation
- Results of financial equalisation

#### **6 4 1 Purpose of financial equalisation**

The foundation for financial equalisation (*Finanzausgleich*) in Germany is laid in Article 20 (1) of the Basic Law. This fundamental principle describes Germany as a federal state (*Bundesstaatsprinzip*). The federal principle is recognised in the financial arrangements between the *Bund* and the *Länder*, and reflects the general acceptance of federalism in Germany. The Basic Law states clearly in Article 106 that the purpose of financial equalisation is to create a balance in the accommodation of the financial needs of the *Bund* and the *Länder* respectively and to ensure equal living conditions throughout the country.<sup>77</sup> Horizontal financial equalisation has a further aim, namely to ensure a reasonable equalisation of the financial disparity of the *Länder*.

The overall purpose of financial equalisation in Germany consists of two elements, namely a social and an economic element. Socially it is aimed at the provision of equal living conditions throughout the country and economically the focus is on balancing the financial needs of the two levels of government.

Constitutionally all provinces in South Africa have the same role to provide public services, but the disparity in financial capacity between the provinces means that they are not in the same position to fund all these public services. There is a need for some form of financial equalisation.<sup>78</sup> The fact that all major taxes are national taxes, while provinces have significant expenditure responsibilities without the accompanying own financial resources, is a further reason for financial equalisation.

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<sup>77</sup> See the discussion under **5 2**.

<sup>78</sup> See the discussion under **6 2**.

The constitutional provisions regarding financial equalisation are based on Constitutional Principle XXVI, that is part of the political compromise reached during the constitutional negotiations at Kempton Park. The Constitutional Principles provided the basic framework for that new constitution but did not go into detail about issues such as specific constitutional aims. This is perhaps why the purpose of financial equalisation is not stipulated as clearly in the South African Constitution as it is in the German Basic Law. Nevertheless, the purpose of financial equalisation can be ascertained from two provisions, namely section 214 and section 227 of the Constitution. There must be a vertical financial equalisation, in terms of section 214, to provide an equitable distribution of funds between the three spheres of government. The purpose of a horizontal financial equalisation is stated somewhat clearer in section 227, namely, to enable provinces and local government to provide basic services and to perform the functions they are responsible for. It can be inferred from these provisions that the purpose of financial equalisation in South Africa also contains two elements, namely, a social and an economic element. Economically, financial equalisation is aimed at providing a fair distribution of funds to all provinces and local government to fund the public services they are responsible for. Socially, the purpose of financial equalisation is to provide equity, which relates to development, the alleviation of poverty and the improvement of the quality of life for the people of South Africa.<sup>79</sup>

Although the crux of the purpose of financial equalisation in both countries is comparable, the constitutional provisions differ. In comparison with the German Basic Law, the South African Constitution lacks clarity on the specific purpose of financial equalisation and could benefit from the inclusion of a provision that links the founding principles to the purpose of financial equalisation.

#### **6 4 2 Constitutional accommodation**

The essential financial equalisation provisions in the case of Germany are contained in Article 106 and 107 of the Basic Law.<sup>80</sup> The constitutional provisions are

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<sup>79</sup> FFC *Framework Document for Intergovernmental Fiscal Relations in South Africa* (1995) iii.

<sup>80</sup> See the discussion under **5 3**.

complemented by additional legislation, namely the *Finanzausgleichgesetz*.<sup>81</sup> Vertical financial equalisation is determined in Article 106 of the Basic Law, while Article 107 contains the basis for the horizontal financial equalisation.

Article 106 (3) contains both a right to an equal proportion of funds for the *Bund* and the *Länder* and an obligation that their financial needs shall be coordinated in a balanced way. The purpose of financial equalisation is also clearly stipulated in this section, namely to ensure equal living conditions in the whole country. Article 107 of the Basic Law provides for the division of revenue amongst the *Länder* and stipulates further that this legal framework for the horizontal financial equalisation, must be completed by way of federal legislation that carries the consent of the *Bundesrat*, in other words, the *Länder* governments must agree to this legislation. The aim of such legislation must be to ensure a reasonable equalisation of the financial disparity of the *Länder*.

It is evident from the German situation that the provisions in the Basic Law are not only fundamental in providing the legal framework for financial equalisation, but that it also contains some of the detailed arrangements, the balance being provided by federal legislation and a political process of negotiations between the *Bundesrat* and the Federal Government.

The constitutional accommodation of financial equalisation in the case of South Africa is provided by two sections in the Constitution, namely section 214 and section 227.<sup>82</sup> Section 214 contains the basic legal framework for financial equalisation while Section 227 clearly outlines a right for both provinces and local government to an equitable share of nationally raised revenue. It also indicates the purpose of the equitable allocation to these two spheres of government, namely to provide basic services and fund the functions they are responsible for. Unlike the German Basic Law the South African Constitution does not provide an equal right to funds for the national and provincial spheres of government. Section 214 of the Constitution

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<sup>81</sup> The current operative Act is the *Finanzausgleichgesetz (FAG)* of 23 June 1993, which has been replaced by the *Maßstäbengesetz*, 2001, and the *Finanzausgleichgesetz*, 2001, from 1 January 2005.

<sup>82</sup> See discussion under **6 3**.

merely determines that the division, that is both the vertical and the horizontal division, must be equitable, but not equal.

The provisions regarding financial equalisation in the Constitution must be complemented by national legislation that must be supported by the National Council of Provinces.<sup>83</sup> In practice this legislation consists of a “permanent” Act, namely the Intergovernmental Fiscal Relations Act, 97 of 1997, and an annual Act, namely the Division of Revenue Act. There is also a political process, namely the discussions concerning the division of revenue that take place in the Budget Council and the extended Cabinet meeting.

Conceptually a similar approach is thus followed in both Germany and South Africa, namely, to have a basic legal framework on financial equalisation exists in the constitution that also stipulates that there must be further national legislation to complete the legal arrangements. There are, however, differences in the way the constitutional provisions are drafted. In the case of Germany it is evident that the two spheres of government, namely the *Bund* and the *Länder*, have an equal claim to funds from current revenue. This is not the case in South Africa, where the financial equalisation must be done equitably, but not equally amongst three spheres of government, namely national, provincial and local government. The provisions in the Basic Law relating to financial equalisation are also more detailed than the comparable provisions in the South African Constitution.

It is thus apparent from this comparison that the *Länder* in Germany are in a constitutionally stronger position vis-à-vis the *Bund* compared to the position of the South African provinces vis-à-vis the national government, since they have a guarantee of fifty percent of funds from current revenue while provinces have a right to an equitable division that must still be determined by national legislation following a political process. This difference is not insignificant and it impacts clearly on the degree of financial autonomy of *Länder* and provinces. Further the strong position of the *Länder* in the *Bundesrat* implies that legislation on financial equalisation cannot be adopted or implemented without their support. The South African provinces are

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<sup>83</sup> Sec 76 (4) (b) of the Constitution.

not in such a strong position and do not have a legislative veto in the National Council of Provinces.<sup>84</sup> If the political context was different and provinces competed with the national government because the political scene was not dominated by one party, the National Council of Provinces could play a more active role in financial equalisation legislation. The South African system has only been tested in one political context dominated by the ANC. One should bear in mind that the German system functions within a politically competitive environment which impacts differently on the functioning of the system and allows the *Länder* to promote their own interests regarding financial equalisation in the *Bundesrat*.

### 6 4 3 Role of additional legislation

In both Germany and South Africa additional legislation is required in terms of their constitutional provisions, but there are differences in scope and frequency of such legislation.

Article 107 of the Basic Law determines that there must be federal legislation that requires the consent of the *Bundesrat*, that provides the details for the financial equalisation process complementary to Article 106 and 107 of the Basic Law. The frequency of this legislation is not determined in the Basic Law. The current law on financial equalisation was adopted by the German Parliament in 1993<sup>85</sup> and the applicable law prior to that dated from 1988.<sup>86</sup> The *Bundesverfassungsgericht* ordered in its judgement on 11 November 1999 that the current Financial Equalisation Act, 1993, is unconstitutional, but that it can still apply until 1 January 2005 when new legislation in accordance with the Court's judgement must be in place.<sup>87</sup> Such new legislation, namely the Financial Equalisation Act, 2001, has already been adopted by the Federal Parliament on 23 June 2001.<sup>88</sup> Although the Financial Equalisation Act (1993) has a longer-term purpose and effect, the actual calculation of

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<sup>84</sup> See discussion under 6 2; Murray & Simeon "South Africa's financial constitution" 491- 492.

<sup>85</sup> The *Finanzausgleichgesetz* (FAG) of 23 June 1993.

<sup>86</sup> The *Finanzausgleichgesetz* (FAG) of 28 January 1988.

<sup>87</sup> BVerfGE 110,158; Beierl *Reforming Intergovernmental Fiscal Relations in Germany: The Bavarian Point of View* (Sept. 2001) 8.

<sup>88</sup> Anon "Bundesregierung und Länder einigen sich auf Länderfinanzausgleich und Solidarpakt II" [www.bundesregierung.de/dokumente/Themen\\_A-Z/Aufbau-Ost-6771/Laenderfinanzausgleich-und-Sol.htm](http://www.bundesregierung.de/dokumente/Themen_A-Z/Aufbau-Ost-6771/Laenderfinanzausgleich-und-Sol.htm)



the equalisation contributions is done annually in terms of the Act.<sup>89</sup> The additional legislation therefore fulfils an important role to complement and to give effect to the constitutional provisions relating to financial equalisation.

In South Africa the further legislation required in terms of section 214 of the Constitution consists of two Acts of Parliament. The Constitution does not stipulate whether there must be one or more Acts. They are the Intergovernmental Fiscal Relations Act, 97 of 1997, which provides for the structures and procedures applicable in intergovernmental fiscal relations, and an annual Act, namely the Division of Revenue Act. Both these Acts require the consent of the National Council of Provinces.<sup>90</sup> The calculation of the horizontal financial allocation amounts to the nine provinces is done according to a formula adopted by the Budget Council and confirmed by the extended Cabinet meeting. This calculation is based on recommendations by the Financial and Fiscal Commission.<sup>91</sup> The actual amounts allocated to the three spheres of government and to the provinces are listed in the annual Division of Revenue Act.

In comparison, it is clear that the German Financial Equalisation Act (1993) is much more detailed, and much more complex, than the annual Division of Revenue Act in South Africa. In both cases there is an annual determination of the financial equalisation or allocation amounts, but the formulas and processes differ. The formula for the horizontal financial equalisation is spelt out in the Financial Equalisation Act, 1993, the formula for the horizontal allocation of revenue in the case of South Africa, is not contained in the legislation. The complexity of the German legislation complicates the functioning of the financial equalisation system and often causes problems, for example, the questions raised due to changes in the financial capacity ranking of the *Länder* due to the horizontal equalisation contributions.<sup>92</sup>

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<sup>89</sup> See discussion under **5 3 2**.

<sup>90</sup> Sec 76 (4) of the Constitution.

<sup>91</sup> See discussion under **6 3 2**.

<sup>92</sup> See discussion under **5 4 2**.

The respective roles of the *Bundesrat* and the National Council of Provinces (NCOP) differ. Although both these legislative chambers must give their consent to the respective financial legislation, the *Bundesrat*, after the involvement of a mediation committee, has effectively a veto on such legislation.<sup>93</sup> Decisions by the NCOP, after the involvement of a mediation committee, can be overturned by a decision of two thirds of the members of the National Assembly.<sup>94</sup> The *Bundesrat* is therefore in a much stronger position regarding the passing of the required financial legislation than the NCOP, and consequently the *Länder* find themselves in a stronger position vis-à-vis the *Bund* compared to the situation of the provinces vis-à-vis the national government in South Africa.

#### **6 4 4 Results of financial equalisation**

The results of financial equalisation can be considered from different perspectives. In this analysis both the constitutional and the socio-economic perspectives will be considered. A constitutional evaluation of the results of financial equalisation may sound formal and legalistic compared to an evaluation from a socio-economic perspective that looks at the results on the ground. These two perspectives are, however, interrelated and an evaluation of the results of financial equalisation in a constitutional state should take account of both perspectives.

In Germany financial equalisation should constitutionally achieve two results, namely ensuring equal living conditions in the whole country and a reasonable equalisation of the financial disparity of the *Länder*. From a socio-economic perspective it is the first of these two results that must be achieved. The second result is mainly a mechanical exercise through which financial parity must be achieved, but it causes a lot of debate regarding the meaning of “reasonable equalisation”. This is evidenced by the last major court case on financial equalisation before the *Bundesverfassungsgericht* in 1999.<sup>95</sup>

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<sup>93</sup> Art 77 of the Basic Law.

<sup>94</sup> Sec 76 (1) of the Constitution; see discussion under **6 2**.

<sup>95</sup> *BVergGE* 101, 158

Another constitutional result of financial equalisation is that it reduces the financial autonomy of the *Länder*, because of the duty of financially stronger *Länder* to assist financially weaker *Länder*.<sup>96</sup> This duty flows from the federal state principle contained in Article 20 of the Basic Law and the notion of *Bundestreue*. This is an implied result due to the nature of financial equalisation in a decentralised system of government. Häde argues that in applying the principle of *Bundestreue* there is not only a duty on the *Bund* to provide the *Länder* with sufficient financial means to fulfil their constitutional obligations, but also a duty on the financially strong *Länder* to support, within limits, the financially weak *Länder*.<sup>97</sup>

Whether the financial equalisation process in any given financial year achieves the constitutional and socio-economic aim of ensuring equal living conditions, is difficult to measure as the concept of equal living conditions will change over time. This aim was more difficult to achieve in 1990 after the unification of Germany due to the huge differences in financial capacity between the old and the new *Länder* and the differences in their living conditions.<sup>98</sup> Although the situation in the new *Länder* has improved dramatically over the last decade, these *Länder* are still the major beneficiaries of the horizontal financial equalisation process. In general the economic conditions in the new *Länder* are still not on par with the rest of Germany and this requires continued special attention from the *Bund*. The implementation of the financial equalisation process for all the *Länder* from 1 January 1995, could not bring the socio-economic development of the new *Länder* to the same level of the old *Länder*. Against this background the Federal Government and the Ministers-President of the 16 *Länder* agreed on 23 June 2001 to a revised financial equalisation process and a new solidarity agreement (*Solidarpakt II*) between the old and new *Länder*. This was aimed at the economic and social development of the new *Länder*.<sup>99</sup> This financial assistance and economic development “package” contains

<sup>96</sup> Art 106 (3) and 107 of the Basic Law; *BVerfGE* 1, 117 131.

<sup>97</sup> Häde *Finanzausgleich* (1996) 257; Mackenstein *From Cohesion Policy to Financial Equalisation?* (1997) 88; Kämmerer “Maßstäbe für den Bundesfinanzausgleich? – Dramaturgie einer verhinderten Reform” 2003 *JuS Heft* 3 214.

<sup>98</sup> See discussion under 5 4. Renzsch “Neuregelung der Bund/Länder-Finanzbeziehungen: Volle Einbeziehung der neuen Länder ab 1995” *Gegenwartskunde* 1/1994 75; Peffekoven “Finanzausgleich in vereinten Deutschland” *Wirtschaftsdienst* 1990/VII 346 347.

<sup>99</sup> Anon “Bundesregierung und Länder einigen sich auf Länderfinanzausgleich und Solidarpakt II” [www.bundesregierung.de/dokumente/Themen\\_A-Z/Aufbau-Ost-6771/Laenderfinanzausgleich-und-](http://www.bundesregierung.de/dokumente/Themen_A-Z/Aufbau-Ost-6771/Laenderfinanzausgleich-und-)

two key components, namely direct financial assistance through the financial equalisation process and payments from the German Unity Fund, and secondly economic development measures to create more jobs and promote more investment in the new *Länder*.<sup>100</sup> In evaluating the results of financial equalisation in Germany, the total package of financial and economic measures, aimed at the socio-economic development of the new *Länder*, will have to be taken into account. Mackenstein stated that financial equalisation in Germany provides a nominal balancing of the per capita revenues of the *Länder*, but that it does not address the underlying structural differences that causes differences in the income positions of *Länder*.<sup>101</sup>

In South Africa financial equalisation must also achieve two results, namely an equitable division of revenue among the three spheres of government and the allocation of appropriate funding to provinces and local government to provide basic services and to fulfil their other constitutional obligations that will enhance the quality of life of their inhabitants. The first result is essentially to achieve parity in the capacity or ability of provinces to provide public services to their inhabitants. From a socio-economic perspective it is the second of these two results that is of critical importance. Provinces and local government are the spheres of government where most of the service delivery takes place and they thus require sufficient funding to fulfil their constitutional mandates and to make a difference in the socio-economic conditions of the community. In the *Intergovernmental Fiscal Review 2001* the National Treasury confirmed the important service delivery role of provinces and local government and concluded that although great progress has been made, the financial intergovernmental system is still evolving and will continue to make an impact on sustainable delivery of services to all South Africans.<sup>102</sup> National Treasury confirmed the common aim of all spheres of government to improve the quality of life of all citizens in the *Budget Review 2003*.<sup>103</sup>

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[Sol.htm](#) ; Bundesministerium der Finanzen “Der neue bundesstaatlichen Finanzausgleich ab 2005” *Monatsbericht 02.2002* (25/02/2002) 99.

<sup>100</sup> Anon “Kabinett verabschiedet den Jahresbericht 2002 zum Stand der Deutschen Einheit” [www.bundesregierung.de/dokumente/Themen\\_A-Z](http://www.bundesregierung.de/dokumente/Themen_A-Z) (4/09/2002) 1.

<sup>101</sup> Mackenstein *From Cohesion Policy to Financial Equalisation?* 107.

<sup>102</sup> National Treasury *Intergovernmental Fiscal Review 2001* 11.

<sup>103</sup> National Treasury *Budget Review 2003* 241.

Most provinces struggled during the first few years after 1994 to implement the new financial intergovernmental system, but as administrative capacity improved, new financial management legislation was implemented and budgeting is now done on the basis of a medium term expenditure framework. Provinces are also playing a more significant role in implementing this system now. According to the *Intergovernmental Fiscal Review 2001* provinces “are consolidating social services delivery, increasing capital expenditure, and enhancing the quality of spending.”<sup>104</sup> Although these positive developments are noted, it is evident that there are capacity related problems in many provinces and municipalities. An important prerequisite for the financial intergovernmental relations system to function properly, is that the various constituent units should be effectively functioning governments. If there is a skills or capacity deficit and a particular government cannot fulfil its functions, it will negatively impact on the whole financial intergovernmental relations system. This situation requires new and creative ways to rectify the problem in order to ensure the effective implementation of the system and compliance with the Constitution.

The South African Constitution requires an “equitable division of revenue” among the provinces compared to the German Basic Law that requires a reasonable equalisation of the financial disparity of the *Länder*. Although the wording of the respective constitutional provisions differ, it seems from the analysis in this and the previous chapter that similar socio-economic results must be achieved, namely an improvement of the living conditions of the people in the whole country.<sup>105</sup>

Whether financial equalisation in South Africa in any particular year has achieved the constitutionally required result, namely an equitable division of revenue among the national, provincial and local spheres of government, is not merely a mathematical calculation. It is a complex issue that includes a whole range of factors that have both a constitutional character, since they are listed in section 214 of the Constitution, and a political character, since the Minister of Finance has a significant influence on the actual division of revenue. This matter has not been argued before the courts and it is debatable whether the Constitutional Court would interfere with a decision by

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<sup>104</sup> National Treasury *Intergovernmental Fiscal Review 2001* 25.

<sup>105</sup> National Treasury *Intergovernmental Fiscal Review 2001* 25.

Parliament to pass the annual Division of Revenue Bill in view of the policy choices inherent in what is essentially a political decision. It is, however, clear that one would be able to judge whether the Division of Revenue Bill adheres to the provisions of the Constitution and therefore if it has achieved the constitutional result envisaged. In other words, the Constitutional Court can decide on the formal aspects of the division of revenue as stipulated in the Constitution, but would be hesitant to interfere with the substantial aspects of the division of revenue that relate to policy choices. The Constitutional Court has indicated that in appropriate circumstances it would use its wide powers to make orders that would affect policy as well as legislation.<sup>106</sup>

Another constitutional result of financial equalisation in South Africa is that it impacts negatively on the relative financial autonomy of provinces. The *Budget Review 2002* confirms the weak position of provinces in the financial equalisation process by stating clearly that the division of revenue is determined by an extended Cabinet meeting that includes the nine Premiers.<sup>107</sup> Although the degree of financial autonomy of the South African provinces and the German *Länder* differs, in both cases their financial autonomy is diminished due to the nature of financial equalisation.

## **6 5 Conclusion**

Financial equalisation is an essential element, and perhaps the most significant element, of the financial intergovernmental relations system in South Africa. The framework or basic provisions governing financial equalisation is found in the Constitution and is amplified by further legislation.

The formulation of the constitutional provisions on financial intergovernmental relations was, according to the FFC, primarily guided by two considerations, namely fiscal autonomy and nation building.<sup>108</sup> The end result is a careful balancing act between these two concepts, but with a strong emphasis on nation building in view of historic and current financial imbalances. The inclusion of specific financial

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<sup>106</sup> *Min of Health v TAC (No 2)* para 113.

<sup>107</sup> National Treasury *Budget Review 2002* 154.

<sup>108</sup> FFC *Intergovernmental Fiscal Relations* 5, 7.

equalisation provisions in the Constitution confirms the importance of equity and equality considerations underlying the concept of nation building, and is aimed at socio-economic development that must improve the quality of life for all citizens of South Africa.

It is evident from the above analysis of financial equalisation in South Africa that the national government plays the leading role, while provinces have limited constitutional scope to exercise influence in the financial equalisation process. This is inter alia evidenced by the fact that the legislative and executive authority over the main tax sources in the country vests in the national government. The chances for new provincial taxes also appear to be limited, in particular after the passing of the Provincial Tax Regulation Process Act, 2001. Constitutionally provinces and local government are guaranteed a right to an equitable share of the pool of nationally raised revenue, but they are still dependant on the national legislation required in terms of section 214 of the Constitution that stipulates the actual division of revenue.

In comparing financial equalisation in Germany and South Africa, it is evident that in both countries the constitutional accommodation of financial equalisation follows a similar model, namely the inclusion of the basic provisions in the constitution together with the stipulation that it must be augmented by further national legislation. There are, however, significant differences. The fundamental principles underlying financial equalisation are explicitly stipulated in the German Basic Law and clearly linked to the provisions for financial equalisation, while this is not the case in the South African Constitution. The purpose of financial equalisation is not so clearly stipulated in the South African Constitution. The comparison further indicates that the German *Länder* are in a constitutionally stronger position than the provinces in South Africa when the allocation of funds and their role in the financial equalisation process is looked at. The financial autonomy of both the *Länder* and the provinces is diminished by financial equalisation.

Although financial equalisation is a comprehensive process that inter alia includes some formula for the actual division of revenue, it appears from the above comparison that the financial equalisation legislation in South Africa is simpler to understand and implement than the German legislation. This does not detract from the fact that

complex formulae are often necessary to underpin the actual financial equalisation in order to give effect to all the constitutional and practical considerations. A further important difference is the fact that the South African legislation allows for a bigger political role in the actual financial equalisation process when compared to the German financial legislation, that is more mechanistic in nature.

The results of financial equalisation can be considered both from a formal constitutional perspective and from a socio-economic perspective. While the financial equalisation legislation has been contested a few times before the *Bundesverfassungsgericht*, it is yet to be seen if and when the comparable South African legislation, namely the Division of Revenue Act, will be considered by the Constitutional Court. The socio-economic results are very much the focus in both Germany and South Africa, but it is difficult, if not impossible, to measure it against the particular constitutional requirements. What is, however, clear is that the respective constitutional aims of ensuring equal living conditions in the case of Germany and the allocation of an equitable division of revenue in South Africa, are not once off events, but are aims that follow a continuum. Although the socio-economic aim of financial equalisation is not clearly defined in the South African Constitution, it appears from important documentation, such as the annual *Intergovernmental Fiscal Review*, that the aim is comparable to that of Germany, namely the improvement of the quality of life for all the people in the country.

Important lessons to be learnt from the German experience are the following:

1. A complex law on financial equalisation with elaborate mathematical exercises is not necessary to give effect to the relevant constitutional requirements, and a simple clear law such as the annual Division of Revenue Act is preferable;
2. It is important to have objective criteria or factors in a formula for the horizontal financial equalisation in order to limit the possibility of arbitrary decisions on the division of revenue;
3. The *Länder* have a significant influence on legislation regarding financial equalisation through their participation in the *Bundesrat*. Such a strong voice for provinces in South Africa is lacking and could enhance accountability at provincial government level;



4. More responsible and accountable provincial government can also be promoted by creating more own sources of revenue for provinces. This is not a simple matter and requires proper consideration of the different needs of the various provinces, some with very low tax capacity, and the needs of the national government, for example, ensuring macro-economic stability and a coherent tax system for raising sufficient funding for financial equalisation purposes. In accordance with economic theory and based on the work done by the FFC, it is argued that it is possible to deal with this issue in a balanced way in order to accommodate the conflicting needs of provinces and the national government;<sup>109</sup>
5. The clear purpose of financial equalisation in Germany as contained in Article 106 (3) of the Basic Law, namely to “ensure equal living conditions in the federal territory”, guides the whole financial equalisation process and has constitutional status. This implies that all financial equalisation legislation must be measured against this objective and stay beyond party politics. It is also clearly linked to the fundamental principles contained in Article 20 of the Basic Law. Although section 227 (1) of the Constitution gives some direction, an overarching aim in the form of a clear statement in the Constitution, which could be linked to the founding provisions in section 1, is lacking in South Africa and should be considered.

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<sup>109</sup> FFC *Recommendations 2001 – 2004 MTEF Cycle* (May 2000) 93. See discussion of economic theory relating to revenue allocation under **3 3**.

## **7 Justiciability of financial constitutional arrangements**

### **7 1 Introduction**

### **7 2 Functions of the constitutional courts in Germany and South Africa**

### **7 3 The contribution of the *Bundesverfassungsgericht* in Germany**

#### **7 3 1 *Financial equalisation case I (BVerfGE 1, 117 – 20/02/1952)***

#### **7 3 2 *Financial equalisation case II (BVerfGE 72, 330 – 24/06/1986)***

#### **7 3 3 *Financial equalisation case III (BVerfGE 86, 148 – 27/05/1992)***

#### **7 3 4 *Financial equalisation case IV (BVerfGE 101, 158 – 11/11/1999)***

### **7 3 5 Comments**

### **7 4 The contribution of the South African Constitutional Court**

#### **7 4 1 *Ex Parte President of the Republic of South Africa: In Re Constitutionality of the Liquor Bill* 2000 1 SA 732 (CC)**

#### **7 4 2 *Soobramoney v Minister of Health, Kwazulu-Natal*, 1997 12 BCLR 1696 (CC)**

#### **7 4 3 *Government of the Republic of South Africa v Grootboom* 2000 11 BCLR 1169 (CC)**

#### **7 4 4 *Minister of Health and Others v Treatment Action Campaign and Others (No 2)* 2002 5 SA 721 (CC)**

#### **7 4 5 *Uthukela District Municipality and Others v The President of the RSA and Others* 2002 11 BCLR 1220 (CC)**

### **7 4 6 Comments**

### **7 5 Conclusion**

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## **Chapter 7 Justiciability of financial constitutional arrangements**

### **7 1 Introduction**

Judicial review, the doctrine of separation of powers and the principle of supremacy of the constitution are cornerstones of the constitutional systems in Germany and in South Africa.<sup>1</sup> This study would be incomplete if it only dealt with the roles of the

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<sup>1</sup> The modern doctrine of separation of powers or *trias politica* is mainly based on the work of Montesquieu, *L'Esprit des Lois*, in the 18<sup>th</sup> century and is widely recognised in various democratic states, although it is only in the USA where an absolute separation of powers is recognised and strictly

legislature and the executive and excluded the judiciary, that has an important role to play in interpreting the applicable legislation and upholding the Constitution. The contribution of the judiciary, in particular the constitutional courts, vis-à-vis the other branches of government in dealing with the theme of this dissertation, warrants special attention. This chapter focuses on the justiciability of the financial constitutional arrangements and the role of the respective constitutional courts in this respect.

What is the basic approach of the South African Constitutional Court with respect to its judicial review function and what can be expected of it when it has to adjudicate disputes involving financial constitutional arrangements?

The legitimacy of judicial review and the need to reconcile it with democratic accountability pose familiar problems that have to be recognized within the context of the present study. The majoritarian principle might be in conflict with that expression of checks and balances that we find embedded in the notion of judicial review. However, the real problem is probably not the existence of this tension or an inherent conflict; but, as Cappelletti has argued, how to reconcile the conflicting principles as much as possible.<sup>2</sup>

At several occasions the Constitutional Court favoured a “conservative” approach with respect to its power of judicial review. Although the certification of the Constitution was a rather unique exercise, the Court expressed itself in favour of a basic conservative philosophy when it stated:

“But this Court has no power, no mandate and no right to express any view on the political choices made by the CA in drafting the NT, save to the extent that such choices may be relevant either to compliance or non-compliance with the CP’s.”<sup>3</sup>

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adhered to. In many other jurisdictions the doctrine is applied in an amended form, e.g. where members of the executive are appointed from the ranks of the legislature, as is the case in South Africa and Germany. See Currie & De Waal *The New Constitutional and Administrative Law Vol I Constitutional Law* (2001) 91; Van der Vyver “The separation of powers” 1993 (8) *SAPR/PL* 177 178.

<sup>2</sup> Cappelletti *The Judicial Process in Comparative Perspective* (1989) xiii.

<sup>3</sup> *In re: Certification of the Constitution of the RSA, 1996* 1996 (4) SA 744 (CC), 1996 (10) BCLR 1253 (CC) (*First certification case*) para 27.

Here the Court referred to the unique function of certifying the new Constitution; a function performed against the background of the fact that the Constitution entered into force without any plebiscite or popular acceptance process. To be “conservative” under such conditions is to do the obvious.

In the context of the Bill of Rights a conservative approach was confirmed again in a number of instances. In *National Coalition for Gay and Lesbian Equality v Minister of Home Affairs* the Court stated with reference to the principle of separation of powers:

“In essence, however, it involves restraint by the courts in not trespassing onto that part of the legislative field which has been reserved by the Constitution, for good reason, to the legislature.”<sup>4</sup>

In *S v Makwanyane* the Court emphasized another aspect regarding the interpretation of the Constitution, in particular the Bill of Rights, when it stated that constitutional interpretation should be done in a purposive and generous way that “gives expression to the underlying **values** of the Constitution.”<sup>5</sup> Malherbe argues that this approach does not only apply in Bill of Rights cases, but also in disputes regarding the autonomy of provinces.<sup>6</sup> This view may be problematical because it purports to elevate the institutional arrangements regarding the relationship between the provinces and the national government to the level of basic constitutional values. That is problematical for several reasons. Article 1 of the Constitution does not support such a view and the historical roots of the provinces are simply too recent.

The overall impression is that the Court will follow a conservative approach in cases concerning intergovernmental disputes. This is an area where the need for transition and transformation is very evident and the underpinning “value” may indeed be one that recognises the need for poverty relief and equalisation.

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<sup>4</sup> 2000 (2) SA 1 (CC) para 66; *Ferreira v Levin NO* 1996 (1) SA 984 (CC), 1996 (1) BCLR 1 (CC) para 183; Currie & De Waal *Constitutional and Administrative Law* 116.

<sup>5</sup> 1995 (SA) 391 (CC) para 9; Currie & De Waal *Constitutional and Administrative Law* 335 – 338.

<sup>6</sup> Malherbe “The role of the Constitutional Court in the development of provincial autonomy” 2001 (16) *SAPR/PL* 255 263.

The Court must interpret and give meaning to the Constitution and in doing so could find itself in a position where it has to adjudicate matters that include both questions of law and rather clear policy choices of the other branches of government. This could easily happen in disputes regarding financial constitutional issues. There have been very few constitutional disputes about the vertical division of powers, or the “federal” issue, and questions about the equitable division of revenue have not yet come before the Constitutional Court. Nevertheless, it would seem that the Court would follow a minimalist approach in these matters and deal with disputes regarding financial constitutional issues very cautiously. Jurisprudence on these issues would enrich the knowledge and understanding of the provisions of the Constitution and would have given a clearer indication on the question regarding the philosophy of the Court.

In the German constitutional system, the doctrine of the separation of powers is entrenched in the Basic Law, that clearly provides for the separation of the executive, legislative and judicial powers.<sup>7</sup> Although the doctrine is not as strictly applied, as in the case of the United States of America, there is a rather clear distinction between the functions of the three branches of government. The *Bundesverfassungsgericht* has stated that the Basic Law does not provide for an absolute separation of powers, but for checks and balances between the three branches of government.<sup>8</sup> There is also a second form of separation of powers or of hierarchy, namely between the federal level of government and the *Länder*.<sup>9</sup>

In the case of South Africa the doctrine of separation of powers, although not explicitly referred to, is given effect to in the Constitution.<sup>10</sup> Already during the constitutional negotiation process at Kempton Park one of the Constitutional

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<sup>7</sup> Art 20 (2) and (3), 79 (3) of the Basic Law. See Venter *Constitutional Comparison – Japan, Germany, Canada and South Africa as Constitutional States* (2000) 216; Sachs *Grundgesetz Kommentar* (1996) 636; Benda *Der soziale Rechtsstaat* in Benda et al (eds) *Handbuch des Verfassungsrechts der Bundesrepublik Deutschland* (1983) 492.

<sup>8</sup> *BVerfGE* 7, 188; Venter *Constitutional Comparison* 216.

<sup>9</sup> See discussion in **Ch 2**; Herzog *The Separation and Concentration of Power in the Basic Law* in Kirchhof & Kommers (eds) *Germany and its Basic Law* (1993) 391 393.

<sup>10</sup> Devenish “The doctrine of separation of powers with special reference to events in South Africa and Zimbabwe” 2003 (66) *THRHR* 84 96; Currie & De Waal *Constitutional and Administrative Law* 96; Erasmus & De Waal “Die finale Grondwet: Legitimiteit en ontstaan” 1997 (1) *Stell LR* 31 34.

Principles agreed to, required that this doctrine should be adhered to in the new constitution: The Constitutional Court certified that the new constitutional text indeed complies with this requirement.<sup>11</sup> The basic separation of powers between the three branches of government is provided for in sections 43 (legislative authority), 85 and 125 (executive authority) and 165 (judicial authority). Furthermore, the Constitution is characterised by a vertical division of powers between the national, provincial and local spheres of government.<sup>12</sup> In *Executive Council of the Western Cape Legislature v President of the Republic of South Africa*, in confirming the application of the doctrine of separation of powers in South Africa, Chaskalson P stated that a strict separation between the legislature and the executive is not required in Commonwealth countries, but that the independence of the judiciary is indeed a high priority.<sup>13</sup>

The Basic Law, which includes in Article 20 the concept of a *Rechtsstaat*, is the supreme law of Germany and all other law is subject to it.<sup>14</sup> Also, in the case of South Africa the Constitution is supreme, it binds all branches of government and all other law or conduct inconsistent with it, is invalid.<sup>15</sup> It thus forms the basis of the legal order in the country. It is evident that the overarching principle of constitutional supremacy is fundamental to the constitutional orders in Germany and in South Africa, and that it is interwoven with the doctrine of separation of powers. Starck states in this respect that the concept of constitutional supremacy “stands in a

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<sup>11</sup> CP VI: “There shall be a separation of powers between the legislature, the executive and judiciary with appropriate checks and balances to ensure accountability, responsiveness and openness.” See *In Re: Certification of the Constitution of the Republic of South Africa*, 1996 1996 4 SA 744 (CC); 1996 10 BCLR 1253 paras 112 – 113.

<sup>12</sup> Sec 40 (1) of the Constitution. See discussion under **2 2** and **4 2 2**.

<sup>13</sup> *Executive Council of the Western Cape Legislature v President of the Republic of South Africa* 1995 4 SA 877 (CC) paras 55- 60. See also Currie & De Waal *Constitutional and Administrative Law* 92; Rautenbach & Malherbe *Constitutional Law* 3<sup>rd</sup> ed (1999) 86 – 92; *South African Association of Personal Injury Lawyers v Heath* 2001 1 SA 883 (CC); 2001 1 BCLR 77 (CC) paras 22 - 24; *National Coalition for Gay and Lesbian Equality v Minister of Home Affairs* 2000 2 SA 1 (CC) para 66; *De Lange v Smuts NO* 1998 3 SA 785 (CC) paras 44, 60, 61.

<sup>14</sup> Art 20 (3) and 28 (1) of the Basic Law. See discussion under **2 2**; Venter *Constitutional Comparison* 66; Currie *The Constitution of the Federal Republic of Germany* (1994) 18; Von Münch *Staatsrecht Band I* (1993) 133; Klein *The Concept of the Basic Law* in Starck (ed) *Main Principles of the German Basic Law* (1983) 23.

<sup>15</sup> Sec 1 (c) and 2 of the Constitution; Stern “Global constitutional movements and new constitutions” 2002 (17) *SAPR/PL* 154 157; Currie & De Waal *Constitutional and Administrative Law* 74; Malherbe “The role of the Constitutional Court in the development of provincial autonomy” 2001 (16) *SA PR/PL* 255 257; Rautenbach & Malherbe *Constitutional Law* 24 – 25; *De Lille v Speaker of the National Assembly* 1998 3 SA 430 (C) paras 22 – 25, 30; *Executive Council of the Western Cape Legislature v President of the Republic of South Africa* paras 61 - 62.

symbiotic relationship to the separation of powers, since it is in itself an indispensable pre-condition for the supremacy of the constitution.”<sup>16</sup> Although all three branches of government must function within the parameters of the Constitution and respect the Constitution as the supreme law, an independent judiciary is essential for the effective protection of constitutional supremacy.<sup>17</sup>

The *Bundesverfassungsgericht* in Germany and the South African equivalent, the Constitutional Court, were established as the highest courts in each country with the primary function to protect the constitution.<sup>18</sup> In both cases, these ‘supreme’ courts are very powerful constitutional institutions that must protect the rule of law and the constitutions in their respective countries.<sup>19</sup> The status of both these courts as constitutional institutions of the highest order and not merely ordinary courts of justice, is emphasised by the fact that the Basic Law and the Constitution respectively provide their powers and specifically mandate the constitutional courts to be the guardians of the constitution.

This thesis does not only consider the constitutional framework for the distribution of financial resources and obligations, but due to the nature of the subject also addresses related issues, such as the economic and financial considerations in the design of decentralised systems of government and some of the policy considerations that play a role in government decisions regarding the distribution of funds. Constitutional and other legal provisions regarding financial intergovernmental relations, must by implication, be justiciable in view of the supremacy of the Constitution. However, the application of these provisions often involves policy issues. This raises the question of the extent of constitutional review of executive decisions and of legislation

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<sup>16</sup> *Constitutional Interpretation* in Starck (ed) *Studies in German Constitutionalism* (1995) 47 52; see also Rautenbach & Malherbe *Constitutional Law* 11.

<sup>17</sup> Ackerman J in *De Lange v Smuts* NO 1998 3 SA 785 (CC) para 47. See also Anon “Mbeki: Judges are independent” *The Natal Witness* 13 August 2003 [www.witness.co.za/content/2003\\_07/16821.htm](http://www.witness.co.za/content/2003_07/16821.htm).

<sup>18</sup> Art 20, 92 and 93 of the Basic Law; Sec 1, 165, 166 and 167 (3) of the Constitution (the Constitutional Court was already created by the 1993-Constitution); Currie & De Waal *Constitutional and Administrative Law* 21. In Germany there are also five other federal courts in specific fields of law, namely the Federal Court of Justice, Federal Administrative Court, Federal Labour Court, Federal Fiscal Court and the Federal Social Court (Art 95 of the Basic Law).

<sup>19</sup> Erasmus & De Waal 1997 (1) *Stell LR* 43; Claassen “The functioning and structure of the constitutional court” 1994 (57) *THRHR* 412 413; Simon *Verfassungsgerichtsbarkeit* in Benda et al *Handbuch des Verfassungsrechts der Bundesrepublik Deutschland* (1983) 1253 1268.

especially as it relates to questions of financial constitutional law. What is the scope of the jurisdiction of the *Bundesverfassungsgericht* and the Constitutional Court respectively in this regard? This question will be discussed below by reviewing a number of key judgments of the two courts.

## 7.2 Functions of the constitutional courts in Germany and South Africa

The Basic Law in Articles 92 and 93 clearly determine the role and status of the *Bundesverfassungsgericht* as one of Germany's supreme constitutional institutions, namely that it is responsible for adjudicating disputes regarding the interpretation and application of the Basic Law, in other words, upholding the Basic Law (giving effect to the principle of constitutional supremacy) and protecting the *Rechtsstaat*.<sup>20</sup> In fulfilling this role the *Bundesverfassungsgericht* is inter alia mandated to rule on:

- ❖ disputes about the infringement of basic human rights;<sup>21</sup>
- ❖ disputes between the *Bund* and the *Länder*;<sup>22</sup>
- ❖ constitutionality of federal or *Land* legislation for example legislation on financial equalisation ('concrete' review);<sup>23</sup> and
- ❖ abstract judicial review of legislation at the request of the Federal Government, a *Land* Government or one third of the members of the *Bundestag*.<sup>24</sup>

One of the most significant changes to the constitutional order in South Africa in 1994 was the creation of the Constitutional Court. It was established by section 98 of the

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<sup>20</sup> Art 13 of the Law on the Federal Constitutional Court (*Bundesverfassungsgerichtsgesetz*) of 12 March 1951; Holle *Das Verfassungsgericht der Republik Südafrika* (1997) 63; Anon *Law on the Federal Constitutional Court in Documents on Democracy in the Federal Republic of Germany* (1994) 3; Doehring *The function of the German Constitutional Court in its capacity as the principal guardian of the Constitution, of the Rule of Law and of Democracy* in Anon *The example of Federalism in the Federal Republic of Germany* (1994) 174 178.

<sup>21</sup> Art 93 (1) 4a of the Basic Law; Art 13 (1) of the Law on the Federal Constitutional Court; Schlüter "The German constitutional court" 1998 (2) *TSAR* 284 285; Simon *Verfassungsgerichtsbarkeit* 1264.

<sup>22</sup> Art 93 (1) 3, 4 of the Basic Law; Art 13 of the Law on the Federal Constitutional Court; Schlüter 1998 (2) *TSAR* 287; Simon *Verfassungsgerichtsbarkeit* 1263.

<sup>23</sup> Art 100 (1) of the Basic Law; Art 13 (11) of the Law on the Federal Constitutional Court; Schlüter 1998 (2) *TSAR* 289; Simon *Verfassungsgerichtsbarkeit* 1265.

<sup>24</sup> Art 93 (1) 2 of the Basic Law; Art 13 (6) of the Law on the Federal Constitutional Court; Schlüter 1998 (2) *TSAR* 288; Simon *Verfassungsgerichtsbarkeit* 1265.



1993-Constitution and denoted as the highest court in South Africa on all matters relating to the interpretation, protection and enforcement of the Constitution. It could, however decide only constitutional matters. This was confirmed by section 167 of the Constitution.<sup>25</sup> The primary role of the Constitutional Court, that is the highest court in all constitutional matters, is to uphold the principle of supremacy of the Constitution and to protect the *Rechtsstaat*. The Constitutional Court confirmed this principle in the following words:

“First the Constitution is elevated to supremacy over all law, and then all organs of state are enjoined to honour and enforce that supremacy.”<sup>26</sup>

Similar to the position under the German Basic Law the functions of the Constitutional Court are enumerated in the South African Constitution. The Constitutional Court may only decide constitutional matters and has exclusive jurisdiction over:

- ❖ disputes between organs of state in the national or provincial sphere of government concerning their constitutional status, powers or functions;<sup>27</sup>
- ❖ applications regarding the constitutionality of any provincial or parliamentary Bill;<sup>28</sup>
- ❖ applications regarding the constitutionality of any provincial or national Act, if such an application is brought by one third of the members of the National Assembly or by one fifth of the members of a provincial legislature;<sup>29</sup>
- ❖ the constitutionality of amendments to the Constitution;<sup>30</sup>

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<sup>25</sup> While the basic functions of the Constitutional Court are stipulated in sec 167 (3), (4) and (5) of the Constitution, the Constitutional Court Complementary Act, 13 of 1995, regulates matters incidental to the functioning of the Constitutional Court.

<sup>26</sup> *Du Plessis v De Klerk* 1996 3 SALR 850 (CC) para 128. See also Currie & De Waal *Constitutional and Administrative Law* 74; *Fedsure Life Assurance Ltd v Greater Johannesburg Metropolitan Council* 1998 2 SA 374 (CC) para 56; *Executive Council of the Western Cape Legislature v President of the Republic of South Africa* 1995 4 SA 877 (CC) para 62.

<sup>27</sup> Sec 167 (4) (a) of the Constitution.

<sup>28</sup> Sec 167 (4) (b) of the Constitution.

<sup>29</sup> Sec 167 (4) (c) of the Constitution; Malherbe & Brand *South Africa – Sub-national Constitutional Law* in Alen et al (eds) *International Encyclopaedia of Laws: Sub-national Constitutional Law* (2001) 71; Venter *Constitutional Comparison* 101; Rautenbach & Malherbe *Constitutional Law* 256; Sarkin “The political role of the South African Constitutional Court” 1997 (114) *SALJ* 134 145; Claassen 1994 *THRHR* (57) 419.

<sup>30</sup> Sec 167 (4) (d) of the Constitution.

- ❖ questions about the non-fulfilment of a constitutional obligation by Parliament or the President;<sup>31</sup> and
- ❖ the certification of a provincial constitution.<sup>32</sup>

In disputes concerning the constitutional validity of legislation or the constitutionality of the conduct of the President, the Constitutional Court has concurrent jurisdiction with the High Court and the Supreme Court of Appeal but must make the final order.<sup>33</sup>

In view of its particular scope of responsibilities, the Constitutional Court has indeed a significant potential to influence the future constitutional development of South Africa, and has since its inception in 1994 made an important contribution in interpreting, protecting and enforcing the Constitution as the supreme law of South Africa.<sup>34</sup>

A critical question in this chapter is; What is the scope of jurisdiction of the Constitutional Court and of the *Bundesverfassungsgericht* in financial constitutional matters? In other words, what is the relationship between these courts and the legislative and executive arms of government in financial constitutional matters? It is evident from the provisions in the Basic Law and the Constitution respectively, that both the *Bundesverfassungsgericht* and the Constitutional Court have the power to review the constitutionality of legislation. This includes concrete review, in other words, where the disputed legal rule is applied and is part of the subject matter before court, and abstract review, where the court has to review the constitutionality of a law without it being applied in an actual case.<sup>35</sup>

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<sup>31</sup> Sec 167 (4) (e) of the Constitution.

<sup>32</sup> Sec 167 (4) (f) of the Constitution; *In re: Certification of the Constitution of the Western Cape*, 1997 9 BCLR 1167 (CC), 1997 4 SA 795 (CC); *In re: Certification of the Constitution of the Province of KwaZulu-Natal*, 1996 1996 11 BCLR 1419 (CC), 1996 4 SA 1098 (CC).

<sup>33</sup> Sec 167 (5) of the Constitution; *Pharmaceutical Manufacturers Association of SA: In re Ex parte President of the RSA* 2000 2 SA 674 paras 54 – 56; Currie & De Waal *Constitutional and Administrative Law* 280.

<sup>34</sup> *Pharmaceutical Manufacturers Association of SA case* para 55; Watts *Is the New Constitution Federal or Unitary?* in De Villiers *Birth of a Constitution* (1994) 75 85.

<sup>35</sup> Rautenbach & Malherbe *Constitutional Law* 256.

The issue of constitutional review has its origins in American law and was first raised in the judgment of Chief Justice Marshall of the Supreme Court in *Marbury v Madison* in 1803, where the Court confirmed the supremacy of the Constitution and the role of the Supreme Court as guardian of the Constitution. Although the Constitution of the USA does not specifically state that the Supreme Court has a judicial review power, the Chief Justice found that judicial review is inherent in the functions of the judiciary to interpret the law.<sup>36</sup> The judicial review exercised by the Supreme Court is however limited to cases where the question about constitutionality of a law, or executive acts of the state, is incidental to a concrete dispute before the court. Contrary to the position in Germany and South Africa, abstract review is not allowed in American law.<sup>37</sup>

The notion of judicial review is not uncontroversial and is criticised as being anti-democratic and anti-majoritarian in view of the fact that judges are not elected and often appointed for life, while the legislators are democratically elected for a pre-determined period and represent the majority of the population. Furthermore, the court has the power to declare laws adopted by the elected legislature unconstitutional.<sup>38</sup> This debate is essentially a question concerning the legitimacy of the jurisdiction of the court to review decisions of the legislature. While it is evident that judicial review will have a limiting effect on the freedom of the legislative branch of government to legislate, it is also clear that within a constitutional state, the constitution is supreme and it places limitations on the jurisdiction of the legislature. Judicial review by a constitutional court is thus essential to protect the supremacy of the constitution.<sup>39</sup> In a constitutional state, there must therefore be a clear demarcation of functions between the constitutional court and the legislature.

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<sup>36</sup> Art III of the Constitution of the United States of America (17 September 1787) determines that the judicial power of the USA shall vest in one supreme court, as highest court in the country, and other inferior courts established by the Congress. Stern 2002 (17) *SAPR/PL* 261; Venter *Constitutional Comparison* 80.

<sup>37</sup> Simon *Verfassungsgerichtsbarkeit* 1259.

<sup>38</sup> Venter *Constitutional Comparison* 81.

<sup>39</sup> Starck *Constitutional Interpretation* 52.

In Germany, the *Bundesverfassungsgericht* must exercise its power of judicial review in such a way that it does not enter the field of political activities; that is the duty of the executive and legislature. The *Bundesverfassungsgericht* has been criticised in the past for “stretching” its judicial review power to have a quasi-legislative or political character.<sup>40</sup> Despite such criticism, there is general respect for the very important role that the *Bundesverfassungsgericht* plays as guardian of the Basic Law. The Court has imposed on itself the principle of judicial self-restraint. This means that the Court will refrain from making policy choices or interfering in the area of politics.<sup>41</sup>

Under the Basic Law, the Federal Parliament is free to legislate and determine its priorities, as long as there is no constitutional limitation that inhibits the scope of its legislative jurisdiction. Likewise, the Federal Government enjoys freedom of decision-making and determining policy priorities in governing the country. Although the *Bundesverfassungsgericht* has the power of judicial review, it does not have the power to determine if the Federal Parliament or the Federal Government has made a good or a bad decision.<sup>42</sup> Policy choices and determination of government priorities are the domain of the executive and legislative branches of government and not that of the judiciary. In the execution of judicial review the *Bundesverfassungsgericht* can give clear direction to the legislature and the executive if a law does not comply with the provisions of the Basic Law, and in doing so, the Court contributes to the further development of the law in Germany.<sup>43</sup>

The judicial authority and independence of the courts in South Africa are explicitly provided for in section 165 of the Constitution.<sup>44</sup> The scope of jurisdiction of the

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<sup>40</sup> Kommers *The Constitutional Jurisprudence of the Federal Republic of Germany* 2<sup>nd</sup> ed (1997) 56.

<sup>41</sup> BVerfGE 36, 1 14; Venter *Constitutional Comparison* 94; Schlüter 1998 (2) TSAR 285; Starck *Constitutional Interpretation* 54; Simon *Verfassungsgerichtsbarkeit* 1279.

<sup>42</sup> Simon *Verfassungsgerichtsbarkeit* 1280; BVerfGE 4, 157 168.

<sup>43</sup> BVerfGE 56, 54; BVerfGE 34, 269; Kommers *Constitutional Jurisprudence* 125.

<sup>44</sup> Sec 165:

“ (1) The judicial authority of the Republic is vested in the courts.  
 (2) The courts are independent and subject only to the Constitution and the law, which they must apply impartially and without fear, favour or prejudice.  
 (3) No person or organ of state may interfere with the functioning of the courts.  
 (4) Organs of state, through legislative and other measures, must assist and protect the courts to ensure the independence, impartiality, dignity, accessibility and effectiveness of the courts.

Constitutional Court in South Africa vis-à-vis the executive and the legislature is aptly described in the following two cases, namely, *S v Makwanyane*,<sup>45</sup> a case involving the interpretation of the Bill of Rights and in which the death penalty was found to be unconstitutional, and *Executive Council of the Western Cape Legislature v President of the Republic of South Africa*,<sup>46</sup> a dispute between two levels of government concerning the constitutionality of national legislation. In *S v Makwanyane* the Court explained the new constitutional order that is based on the principle of constitutional supremacy and said that judicial review of all legislation and the adjudication of disputes regarding human rights are placed in the hands of the courts. This is an important part of the new constitutional order.<sup>47</sup>

In the *Western Cape-case* the Constitutional Court was even more explicit and stated that it will not interfere in the realm of the executive or the legislative branch of government, but that it had a clear mandate to interpret the Constitution and to uphold the principle of constitutional supremacy.<sup>48</sup> The Court described its role as follows:

“Our duty is to declare legislative and executive action which is inconsistent with the Constitution to be invalid, and then to deal with the consequences of the invalidity in accordance with the provisions of the Constitution.”<sup>49</sup>

These judgments provided a solid foundation for the application of judicial review by the Constitutional Court in South Africa and, together with the clear authorization in the Constitution, effectively dealt with any anti-majoritarian arguments that might be raised. The undisputed position of the *Bundesverfassungsgericht* and the Constitutional Court as courts entrusted with the responsibility of guardians of the Basic Law and the Constitution respectively, lays the foundation for their authority to

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(5) An order or decision issued by a court binds all persons to whom and organs of state to which it applies.”

<sup>45</sup> 1995 3 SA 391 (CC).

<sup>46</sup> 1995 4 SA 877 (CC).

<sup>47</sup> *Makwanyane-case* para 88; Currie & De Waal *Constitutional and Administrative Law* 65; Venter *Constitutional Comparison* 83.

<sup>48</sup> *Western Cape-case* paras 99 and 100; Venter *Constitutional Comparison* 84.

<sup>49</sup> *Western Cape-case* para 100. See also *President of the RSA v United Democratic Movement* 2003 1 SA 472 (CC) para 31.

decide matters pertaining to the division of functions between the spheres of government and financial intergovernmental relations.

In matters such as the division of functions or allocation of financial resources to the various spheres of government, disputes are partly of a constitutional-legal nature and partly of a discretionary political nature and obvious policy implications are involved. However, this dividing line is not always clear. It is the task of the constitutional courts to provide guidance to the other organs of state for the interpretation and application of the Basic Law and the Constitution respectively. In doing so, they must always be conscious of their role as judges in the constitutional scheme of things and of the separation of powers, that allows for checks and balances among the three branches of government.<sup>50</sup>

### **7 3 The contribution of the *Bundesverfassungsgericht* in Germany**

In fulfilling its role as guardian of the Basic Law and upholding the principle of constitutional supremacy, the *Bundesverfassungsgericht* is responsible for judicial review of legislation and other official acts by the other organs of state and for adjudicating disputes between organs of state.<sup>51</sup> Always conscious of the separation of powers and the interplay between the three branches of government, the *Bundesverfassungsgericht* plays a key role in giving effect to and interpreting the Basic Law. This includes the adjudication of constitutional disputes in the area of financial intergovernmental relations.

In interpreting the Basic Law the *Bundesverfassungsgericht* would apply the ordinary or conventional canons of interpretation, for example giving effect to the ordinary meaning of words and understanding the linguistic usage of terminology.<sup>52</sup> Although this is the general approach, it should be noted that different considerations should be taken into account in disputes about human rights compared to disputes concerning the structural principles of the constitution and matters of organisation, procedures

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<sup>50</sup> Kommers *Constitutional Jurisprudence* 164.

<sup>51</sup> Kommers *Constitutional Jurisprudence* 37 ; Art 13 of the *Bundesverfassungsgerichtsgesetz* (Law on the Federal Constitutional Court (1951); Venter *Constitutional Comparison* 91

<sup>52</sup> Starck *Constitutional Interpretation* 54.

and competences. Interpretation of fundamental rights includes a clear value orientation that lacks in disputes of an organisational or intergovernmental nature. In human rights cases the central issue is giving effect to an individual's fundamental right vis-à-vis the state. The scope of protection of fundamental rights is not without boundaries and can be limited. The principle of proportionality would guide the *Bundesverfassungsgericht* in considering if the limitation of a fundamental right is constitutionally justifiable.<sup>53</sup> In the Basic Law, the structural principles are interlinked and cannot be interpreted in isolation. This is evident from the wording of Article 20 (1), that states that Germany is a “democratic and social federal state”, and in Article 28 (1), where reference is made to “the principles of the republican, democratic and social state.”<sup>54</sup> In interpreting the individual structural principles, the basic rule is that the courts must consider the expression of the structural principles within the constitutional provisions on organisation, procedures and division of competences.<sup>55</sup> This means that a court would not interpret the principle of a federal state in isolation, but would look at other provisions in the Basic Law where this principle is expressed, for example Article 84 (implementation of federal legislation by the *Länder*). Bayer states in this respect that *Bundestreue* is a general legal principle which gives expression to the federal state principle and which direct intergovernmental relations in practice.<sup>56</sup>

The creation of the *Bundesverfassungsgericht* as a federal constitutional organ followed on various discussions during the constitutional negotiations prior to the adoption of the Basic Law in 1949. Its role and wide jurisdiction to adjudicate all constitutional disputes, including the review of legislation, were the result of many discussions and negotiations between delegates in the Parliamentary Council in Bonn in 1948. For five decades the *Bundesverfassungsgericht* played its part alongside the other federal organs, such as the Federal Government and the Federal Parliament, to shape the constitutional landscape in Germany. Between 1952 and 2002, there were a

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<sup>53</sup> Starck *Constitutional Interpretation* 61.

<sup>54</sup> See discussion under 2 1 2; Venter *Constitutional Comparison* 93.

<sup>55</sup> Starck *Constitutional Interpretation* 65.

<sup>56</sup> Bayer *Die Bundestreue* (1961) 126.

few milestone decisions by the *Bundesverfassungsgericht* that guided the development of financial intergovernmental relations in Germany.

An important aspect of the contribution of the *Bundesverfassungsgericht* is the development of the concept of *Bundestreue*, also within the context of financial intergovernmental relations. *Bundestreue*, that is an expression of the federal state principle, is fundamental to the relationship between the *Bund* and the *Länder*.<sup>57</sup> The Basic Law does, however, not mention the obligation to respect federal loyalty or *Bundestreue*. Historically the concept of *Bundestreue* not only explained the relationship between the *Bund* and the *Länder*, but it was regarded as a functional principle that gave clear expression to the federal character of the state.<sup>58</sup> In some of the earlier disputes of an intergovernmental nature before the *Bundesverfassungsgericht* the Court had to reflect on the nature of the relationship between the *Bund* and the *Länder* and give meaning to the federal state principle. This led the Court to expressly recognise the concept of *Bundestreue* in applying the federal state principle and to state clearly that both levels of government have a duty to act in a “federal friendly” manner.<sup>59</sup> Today *Bundestreue* is commonly accepted as a general legal norm that directs the relations between the *Bund* and the *Länder* as well as the relations among the *Länder*. The *Bundesverfassungsgericht* has applied the concept of *Bundestreue* in later disputes between the two levels of government. Some of these disputes will be discussed below.

The basic framework for the division of functions (Articles 70 – 75) and the distribution of financial resources to the *Bund* and the *Länder* (Articles 104a – 107) are provided in the Basic Law and the financial provisions are supplemented by further federal legislation. The result has been the development in Germany of a rather well-developed branch of constitutional law consisting of constitutional provisions, legislation and constitutional case law. It is in particular the financial provisions that caused disputes amongst the *Länder* and between the *Länder* and the *Bund* that were brought before the *Bundesverfassungsgericht* for decision. Some of these key decisions are reviewed in this section.

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<sup>57</sup> Bayer *Die Bundestreue* 83 – 87. See discussion of *Bundestreue* under **1 1 4** and **1 2**.

<sup>58</sup> Bayer *Die Bundestreue* 32.

<sup>59</sup> BVerfGE 1, 117; Bayer *Die Bundestreue* 83, 87.



### 7 3 1 *Financial equalisation case I (BVerfGE 1, 117 – 20/02/1952)*

The first dispute regarding financial equalisation was brought before the *Bundesverfassungsgericht* only a few years after the new Basic Law was implemented (1949) and the financial intergovernmental relations system was still in its infancy. This took place against the backdrop of a country that had just started massive rebuilding and development in an attempt to deal with the devastating effects of World War II. The shadows of the War and the occupation of Germany were also influential during this dispute before the Court. In fact, the influence of the Western Occupation Forces on the rebuilding of Germany and on the shaping of the financial intergovernmental relations was evident.

Two of the *Länder*, namely Württemberg-Baden (as it was then known) and Hamburg, initiated this case by questioning the constitutionality of the financial equalisation legislation (*Finanzausgleichgesetz*) of 1950. The application was opposed by the federal government, the *Bundestag* (Lower House of the German Parliament) and the Governments of the *Länder* Bavaria, Rheinland-Pfalz and Schleswig-Holstein. The Court had to decide the following fundamental questions:

- i. Is the financial equalisation system, including the *Finanzausgleichgesetz*, compatible with the federal principle and the federal structure of Germany?;
- ii. How must the income of the whole state be divided between the *Bund* and the *Länder* (vertical financial equalisation)?;
- iii. How can the differences in financial capacity and obligations among the various *Länder* be equalised (horizontal financial equalisation)? and

- iv. Does the *Finanzausgleichgesetz* of 1950 comply with Article 106 (4) of the Basic Law?<sup>60</sup>

In deciding these questions, the Court referred to the historical developments preceding the adoption of the Basic Law, particularly Article 106. The question regarding the division of finances, including the issue of financial equalisation, had been the subject of discussion by the Western Occupation Forces and later also by the Parliamentary Council (*Parlamentarische Rat*). The Protocol of the Finance Committee and the Main Committee of the Parliamentary Council, that contained proposals for a new constitution, included the following decisions of 10 February 1949 concerning the future financial intergovernmental relations of Germany:

- i. The division of federal taxes between the *Bund* and the *Länder* must be done in accordance with the allocation of obligations to the two levels of government and in such a way that the *Länder* receive a statutory right to the allocation of specific federal taxes, or to a share of specific federal taxes.
- ii. Further detail of financial equalisation must be arranged by way of a financial equalisation law, that must take into account a fair and suitable equalisation of obligations.<sup>61</sup>

The Western Occupation Forces and the military governors had some reservations regarding the decisions of the Parliamentary Council and were particularly concerned that too much power over the division of public finances would be left in the hands of the *Bund*. After discussing their concerns, they came to an agreement with the Parliamentary Council on 25 April 1949, that led to the wording of Article 106 (4) of the Basic Law. While the basic point of departure as contained in the above decisions of the Parliamentary Council, was generally accepted, it was decided that provision

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<sup>60</sup> Art 106 (4): “The respective shares of the Federation and the *Länder* in turnover tax revenue shall be reapportioned whenever the ration of revenue to expenditure differs substantially as between the Federation and the *Länder*. Where federal legislation imposes additional expenditure on or withdraws revenue from the *Länder* the additional burden may be compensated by federal grants pursuant to a federal law requiring the consent of the *Bundesrat* provided that the burden is limited to a short period. The law shall lay down the principles for computing such grants and distributing them among the *Länder*.”

<sup>61</sup> *BVerfGE* 1,117 para 26–36.

must be made in the Basic Law for allowances or grants to be paid by the *Bund* to the *Länder* and to facilitate a process of financial equalisation that would provide some guarantees to the financially weak *Länder*.<sup>62</sup>

It was further decided that a federal law that required the consent of the *Bundesrat* and resulted from delegations from all the *Länder*, may allocate part of the revenue from income and corporate tax (federal taxes) to pay allowances to *Länder* to fund their constitutionally allocated functions or obligations, in other words, provision was made for the statutory accommodation of financial equalisation. This crucial agreement laid the foundation for the further development of the financial equalisation system, including the principle that the *Bund* and the *Länder* have an equal right to the income derived from income and corporate tax in order to fund their respective obligations.<sup>63</sup>

Although Germany was in ruins at the end of World War II, the economic needs and the ability to recover differed from one area to another. The *Bund* and the *Länder* carried the burden of payment of war debts. The idea of some form of horizontal financial equalisation, to assist the financially weak *Länder*, was realised for the first time in 1949 when a law on the settlement of war debts in the Combined Economic Area was implemented.<sup>64</sup> This law required the financially stronger *Länder* within the Combined Economic Area, to make monthly contributions from the revenue of consumer tax that accrued to the *Länder* to the Administration of the Combined Economic Area.<sup>65</sup> These funds were to be used to make monthly payments to the financially weaker *Länder*, to assist them with the payment of their war debts. A further law on the settlement of war debts included the *Länder* in the French occupied zone, where payments were made to the *Bund* who was responsible for making

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<sup>62</sup> *BVerfGE* 1, 117 para 41 – 42.

<sup>63</sup> Klein *Bund und Länder nach der Finanzverfassung des Grundgesetzes* in Benda *Handbuch des Verfassungsrechts* 863 884; Von Münch *Grundgesetzkommentar* (1983) 801.

<sup>64</sup> The *Gesetz des Wirtschaftsrats zur vorläufigen Regelung der Kriegsfolgelasten im Rechnungsjahr 1949* of 6 August 1949; *BVerfGE* 1, 117 para 8.

<sup>65</sup> The Combined Economic Area consisted of the areas within the British and American zones and included the *Länder* Hessen, Württemberg-Baden, Bavaria, Bremen, Hamburg, Schleswig-Holstein, Lower Saxony and North Rhine Westphalia; Laufer & Münch *Das föderative System der Bundesrepublik Deutschland* (1997) 62.

monthly payments to the financially weaker *Länder*.<sup>66</sup> These laws preceded the *Finanzausgleichgesetz* (financial equalisation law) of 1950, that was based on the provisions of Article 106 (4) of the Basic Law.<sup>67</sup>

In this case before the *Bundesverfassungsgericht*, the *Land* Württemberg-Baden argued that Article 106 (4) of the Basic Law created the possibility for federal legislation to allow a general financial equalisation amongst the *Länder* and not merely to provide for the payment of federal grants to individual *Länder*. Such a situation, it was argued, is against the federal principle contained in Article 20 of the Basic Law and undermined the financial autonomy of the *Länder*. The *Bundesverfassungsgericht* confirmed that *Bundestreue* must be given effect to and that there is a duty on the *Bund* and the *Länder* to respect the overall financial situation of both levels of government.<sup>68</sup> The *Bundesverfassungsgericht* decided that the federal principle contained in Article 20, and guaranteed in Article 79, of the Basic Law does not only imply rights, but also implies duties, one of which is that the financially stronger *Länder* should, within specific limits, provide assistance to financially weaker *Länder*.<sup>69</sup> This inevitably causes a limitation on the financial autonomy of the *Länder*. To compensate partially for this loss of autonomy, Article 109 of the Basic Law determines inter alia that the Federation and the *Länder* shall be autonomous and mutually independent in their budget management. The Court concluded that the framework for financial equalisation contained in the Basic Law is compatible with the federal principle. The Court further indicated that this principle would be offended if the financial equalisation legislation provides for financial equalisation in such a way that the financial capacity of the contributing *Länder* is substantially weakened or if it could lead to an absolute equalisation or financial levelling (*Nivellierung*) of the *Länder*.<sup>70</sup> This important decision by the Court guided the further development of financial equalisation in Germany and the later judgments given by the Court.

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<sup>66</sup> The *Bundesgesetz zur Regelung von Kriegsfolgelasten im 2. Rechnungshalbjahr 1949* of 21 March 1950.

<sup>67</sup> The *Bundesgesetz über den Finanzausgleich unter den Ländern im Rechnungsjahr 1950* of 16 March 1951 (FAG).

<sup>68</sup> Kommers *Constitutional Jurisprudence* 72.

<sup>69</sup> *BVerfGE* 1, 117 para 44.

<sup>70</sup> *BVerfGE* 1, 117 para 45; Kommers *Constitutional Jurisprudence* 91; Häde *Finanzausgleich* (1996) 217 – 218.

According to the *Bundesverfassungsgericht* the *Finanzausgleichgesetz* of 1950 provided for a financial equalisation mechanism that consists of a series of calculations. The financial capacity of each *Land* is determined by taking into account the total tax income of that *Land*, including its municipalities, available to fund the obligations it has but excluding those obligations that have national importance. This amount is known as the financial capacity of a *Land*. The average financial capacity of all the *Länder* divided by the total population results in a figure known as the equalisation measure (*Ausgleichsmeßzahl*). The Court further stated that the financial capacity measure (*Finanzkraftmeßzahl*), that is the financial capacity divided by the population of that *Land*, must be compared with the equalisation measure. The differences between these two figures should be equalised within specified limits. The contributing *Länder* are those *Länder* whose financial capacity measure is higher than their equalisation measure, while the receiving *Länder* are those *Länder* whose financial capacity measure is lower than their equalisation measure. The Court concluded that the *Finanzausgleichgesetz* of 1950 did not lead to an absolute equalisation of the *Länder* and that it was therefore not unconstitutional, but that it in fact complied with the provisions of Article 106 (4) of the Basic Law.

### **7 3 2 Financial equalisation case II (BVerfGE 72, 330 – 24/06/1986)**

A period of more than thirty years elapsed before the *Bundesverfassungsgericht* heard the next dispute regarding financial equalisation. During this period, major reform of the financial intergovernmental relations had taken place and in 1969 the essence of this was the constitutional accommodation of cooperative federalism.<sup>71</sup> In *Financial equalisation case II* six *Länder*, namely Baden-Württemberg, Bremen, Hamburg, Hessen, North Rhine-Westphalia and Saarland, disputed the constitutionality of certain provisions of the *Finanzausgleichgesetz* (Financial Equalisation Act) of 1969<sup>72</sup> and the *Zerlegungsgesetz* (Division of Taxes Act).<sup>73</sup> The crux of this matter was the question concerning how the provisions of Article 107 (1) the division of

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<sup>71</sup> See discussion under 5 2.

<sup>72</sup> *Gesetz über den Finanzausgleich zwischen Bund und Ländern* of 28/08/1969, BGBl I, 1432.

<sup>73</sup> *Gesetzes über die Steuerberechtigung und die Zerlegung bei der Einkommensteuer und Körperschaftsteuer* of 25/02/1971, BGBl I, 145.

revenue from wage tax and (2) horizontal financial equalisation of the Basic Law were interpreted and applied in these pieces of legislation.<sup>74</sup>

The first part of Article 107 (1) determines that revenue from *Land* tax and the *Länder* share of revenue from income and corporation tax, must be divided according to the place of collection of that revenue (*Prinzip der örtlichen Aufkommen*).<sup>75</sup> Federal legislation must specify the breakdown of local revenue from wage and corporation taxes and the way it must be allocated. The *Zerlegungsgesetz* was a federal law that gave effect to this stipulation in Article 107 (1) of the Basic Law and it inter alia provided that revenue from wage tax must be allocated according to the place of residence of the taxpayer (*Wohnsitzprinzip*).<sup>76</sup>

The city-states of Bremen and Hamburg, that have a large number of commuters that work in those *Länder* but live in some of the neighbouring *Länder*, argued that they lose a substantial amount of revenue because the wage tax is collected at the place of residence of the taxpayer. They further argued that their expenditure responsibilities include amongst other things the provision of roads and schools for all their inhabitants and for the commuter workers and that they should thus be able to retain the tax income generated from these commuters. The Court regarded Article 107 (1) of the Basic Law as part of the framework of the financial constitution, and accepted

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<sup>74</sup> Art 107 (1): “Revenue from *Land* tax and the *Land* share of revenue from income and corporation tax shall accrue to the *Länder* to the extent that the taxes are collected by the revenue authorities in their respective territories (local revenue). Federal legislation requiring the consent of the *Bundesrat* shall specify the breakdown of local revenue from corporation and wage tax as well as the method and extent of its allocation. Such legislation may also provide for the breakdown and allocation of local revenue from other taxes. The *Land* share of revenue from turnover tax shall accrue to the *Länder* on a per capita basis; federal legislation requiring the consent of the *Bundesrat* may provide for supplemental shares not exceeding one quarter of a *Land* share to be granted to *Länder* whose per capita revenue from *Land* taxes and from income and corporation tax is below the average of all the *Länder* combined.

(2) Such legislation shall ensure a reasonable equalization of the financial disparity of the *Länder*, due account being taken of the financial capacity and requirements of the municipalities (associations of municipalities). The legislation shall specify the conditions governing the claims of *Länder* entitled to equalization payments and the liabilities of *Länder* required to make such payments, as well as the criteria for determining the amounts. It may also provide for federal grants to be made to financially weak *Länder* in order to complement the coverage of their general financial requirements (complemental grants).”

<sup>75</sup> *Land* taxes are all the taxes of which the revenue shall accrue to the *Länder*, e.g. inheritance tax and motor vehicle tax; Art 106 (2) of the Basic Law.

<sup>76</sup> Wieland “Die verfassungsrechtliche Rahmenordnung des Finanzausgleichs” 1988 (8) *Jura* 410 412; Mußgnug “Der horizontale Finanzausgleich auf dem Prüfstand des Bundesverfassungsgerichts” 1986 (11) *JuS* 872 873; Klein *Bund und Länder nach der Finanzverfassung* 886.

that it gave the legislator some latitude in shaping the legislation that would give effect to the provisions of this section.<sup>77</sup> It did not, as Bremen and Hamburg argued, require the federal law to stipulate that the revenue from wage tax must be allocated to the place where it is generated. Article 5(1) of the *Zerlegungsgesetz*, that provided that the revenue from wage tax must be allocated to the *Länder* according to the place of residence, was therefore held to be in accordance with the provisions of Article 107 (1) of the Basic Law.<sup>78</sup>

The other important part of this decision related to the interpretation of Article 107 (2) of the Basic Law, in particular the first part that envisages a reasonable financial equalisation of the *Länder*. In terms of the financial reform of 1969, there is a duty on the federal legislature to ensure “a reasonable equalisation” of the financial capacity of the *Länder*. The financial equalisation process consists of three basic steps, namely:

- (i) vertical financial equalisation aimed at providing sufficient financial resources to the *Bund* and the *Länder*;
- (ii) horizontal financial equalisation between the *Länder*; and
- (iii) additional grants transferred by the *Bund* to individual financially weak *Länder* to supplement their specific financial needs.<sup>79</sup>

Article 107 (2) is the basis for the last two steps in the financial equalisation process. In its consideration of the horizontal financial equalisation process the *Bundesverfassungsgericht* analysed the scope of the term “financial capacity” in the context of Article 107 (2). The Court stated that “financial capacity” is a comprehensive term that includes not only the tax capacity of a *Land* but also includes all other revenue that accrues to a *Land*.<sup>80</sup>

The division of financial resources between the *Bund* and the *Länder* is the most visible expression of the constitutional relationship between the various components

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<sup>77</sup> Wieland 1988 (8) *Jura* 8 415.

<sup>78</sup> *BVerfGE* 72,330 333; Wieland 1988 (8) *Jura* 8 415; Mußgnug 1986 (11) *Jus* 874.

<sup>79</sup> See discussion under 5 4; Mußgnug 1986 (11) *JuS* 872 - 873.

<sup>80</sup> Häde *Finanzausgleich* 231; Wieland 1988 (8) *Jura* 416.

of the federal state. The fundamental principle that must be applied here is the federal principle contained in Article 20 of the Basic Law. The Court confirmed that in applying it to the first sentence of Article 107 (2) implies that there is a duty on the financially stronger *Länder* to support the financially weaker *Länder* in such a way that it does not lead to an absolute equalisation (*Nivellierung*) of their financial positions. Those *Länder* that are overall in a financially weaker position must thus be supported by the financially stronger *Länder*.<sup>81</sup> The poor financial position of a *Land* cannot only be attributed to an insufficient own tax base. It is the overall financial position inclusive of all revenue of a *Land* that must be assessed to determine whether a *Land* qualifies to receive support. In this horizontal financial equalisation process, the special needs of individual *Länder* should not be taken into consideration. This would, however, be relevant and taken into account at the end of the financial equalisation process when the *Bund* considers additional allocations from its revenue to individual *Länder*. Additional allocations in terms of Article 107 (3) are aimed at financing those special needs that could not be considered during the horizontal financial equalisation process where the focus is on the general financial capacity of the *Länder*.<sup>82</sup>

The federal legislature must therefore ensure that the financial equalisation legislation is in accordance with Article 107 as interpreted by the Court. The *Finanzausgleichgesetz* of 1969 did not comply with Article 107 (2) since it provided for the special treatment of two *Länder*, namely Hamburg and Bremen, in that it guaranteed them a minimum financial status and was therefore ruled to be unconstitutional. Article 107 (2) requires a reasonable financial equalisation of all the *Länder*.<sup>83</sup> The Court instructed the Federal Parliament to correct the law and set a time limit of two years for them to do so. Within the framework of the Basic Law, more specifically Article 107, the Federal Parliament has the freedom to legislate, as recognised by the Court.<sup>84</sup>

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<sup>81</sup> Wieland 1988 (8) *Jura* 416.

<sup>82</sup> Wieland 1988 (8) *Jura* 417; Mußgnug 1986 (11) *JuS* 877.

<sup>83</sup> *BVerfGE* 72, 330 333; Kommers Constitutional Jurisprudence 91; Wieland 1988 (8) *Jura* 418; Mußgnug 1986 (11) *JuS* 878.

<sup>84</sup> *BVerfGE* 72, 330 333; Wieland 1988 (8) *Jura* 418.



The judgment in this case is not only relevant for the detailed development and implementation of the financial equalisation system, but is also of particular significance for the development of the relations between the *Bund* and the *Länder*. The importance of the federal principle and the duty on the *Bund* to treat the *Länder* on an equal basis in the financial equalisation process were confirmed by the *Bundesverfassungsgericht*.<sup>85</sup> Von Münch stated that financial equalisation is an expression of federal solidarity, a statement that highlights the essence of this judgment.<sup>86</sup> The notion of cooperative federalism received clear support and direction from the Court. The *Länder* in particular have a duty to support each other, and likewise the *Bund* has a duty to support the financially weaker *Länder*. This judgment emphasizes that the successful functioning of the financial equalisation system is dependant on the application of the federal principle. Wieland, in his discussion of this judgment, argued that the federal state could only function optimally if all its constituent parts, namely the *Bund* and the *Länder*, are financially enabled to perform their respective constitutional obligations.<sup>87</sup> This is a reasonable inference from the Court's decision. It is further evident from this judgment that Article 107 of the Basic Law is one of the cornerstones of the financial constitution and as such, an important element of the overall constitutional arrangements in Germany.

### **7 3 3 Financial equalisation case III (BVerfGE 86, 148 – 27/05/1992)**

*Financial equalisation case III*, a judgment by the Second Senate of the *Bundesverfassungsgericht* on 27 May 1992, was the first judgment regarding financial equalisation after the reunification of Germany in 1990. It should be noted that the application of the financial equalisation provisions in the *Länder* of Brandenburg, Mecklenburg-Pomerania, Saxony, Saxony-Anhalt, Thuringia and Berlin was suspended until 31 December 1994 and in terms of the *Einigungsvertrag* (Unification Treaty) special arrangements, such as the German Unity Fund that provided for financial aid of DM 115 billion over five years, were put in place to assist these new

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<sup>85</sup> BVerfGE 72, 330 331; Wieland 1988 (8) *Jura* 415.

<sup>86</sup> Von Münch *GG Komm* 842.

<sup>87</sup> Wieland 1988 (8) *Jura* 418.

*Länder* financially during this transitional period.<sup>88</sup> This case was argued and decided on the legislation as it was prior to unification.

In the previous case regarding financial legislation, namely *Financial equalisation case II* in 1986, the *Bundesverfassungsgericht* held certain provisions of the *Finanzausgleichgesetz* of 1969 to be unconstitutional. The Federal Parliament enacted an amended *Finanzausgleichgesetz* in 1987, which kept the basic structure of the financial equalisation system unchanged but accommodated the directions of the Court to bring the law in line with the provisions of Article 107 of the Basic Law.<sup>89</sup> In 1992 four *Länder*, namely Bremen, Hamburg, Saarland and Schleswig-Holstein, made an application to the *Bundesverfassungsgericht* (*Financial Equalisation Case III*) in which they questioned the constitutionality of various provisions of the applicable financial equalisation legislation. The two main issues under consideration in this case were the scope of the horizontal financial equalisation in terms of Article 107 (2) of the Basic Law and the question of additional financial allocations to financially weaker *Länder*. In addressing these issues, the Court analysed the fairly complex nature of the actual horizontal financial equalisation process. An overview of the most important aspects of this is provided below.

The Court confirmed that the purpose of the division of financial resources is to place the *Bund* and the *Länder* in positions that allow them to fulfil their constitutionally allocated functions or obligations. The financial equalisation process supports this aim and includes all the *Länder* in accordance with the federal principle.<sup>90</sup>

The obligation in Article 107 (2) to ensure a reasonable equalisation of the financial disparity of the *Länder*, with due consideration of the financial capacity and needs of the municipalities, was confirmed by the Court.<sup>91</sup> In giving content to this obligation, the *Finanzausgleichgesetz* (*FAG*) of 1987 provided the detail for a comprehensive

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<sup>88</sup> BVerfGE 86, 148 160; Article 7 of the *Gesetz zu dem Vertrag vom 18. Mai 1990 über einer Währungs-, Wirtschafts- und Sozialunion zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik vom 25. Juni 1990*, (*Gesetz zum Staatsvertrag*) BGBl 1990 II 518. See discussion under **5.4**.

<sup>89</sup> *Achtes Gesetz zur Änderung des Finanzausgleichgesetz* of 18/12/1987, BGBl I 2764.

<sup>90</sup> BVerfGE 86, 148 213.

<sup>91</sup> BVerfGE 86, 148 152; Häde “Solidarität im Bundesstaat” DÖV 46 (1993) 461 462.

horizontal financial equalisation process, the outline of which is as follows. Article 6 *FAG* determined the two yardsticks for the calculation of the equalisation payments, namely, the financial capacity measure (*Finanzkraftmeßzahl*) and the equalisation measure (*Ausgleichsmeßzahl*). While the financial capacity measure of a *Land* consists in general of its revenue and the revenue of its municipalities, Article 7 and 8 *FAG* determined the specific taxes and scope of their inclusion in this calculation. The equalisation measure of a *Land* is derived at by multiplying the number of inhabitants of that *Land* with the average *Länder* revenue per inhabitant. In terms of Article 9 *FAG*, the population of the city-states Bremen and Hamburg is revalued at 135% of their actual number and the population of municipalities of more than 5000 inhabitants is revalued according to a sliding scale based on the density of the population. Article 10 *FAG* determined the scope of equalisation, in other words, to what extent contributing *Länder* must make financial equalisation contributions and to what extent receiving *Länder* would qualify for receiving equalisation contributions. The last section of significance for this case is Article 11a *FAG* that dealt with the question of additional federal allocations (*Bundesergänzungszuweisungen*) to financially weaker *Länder*.

The Court in this case confirmed that the concept of financial capacity must be interpreted comprehensively and that it cannot only include the tax capacity of a *Land*.<sup>92</sup> Article 7 and 8 *FAG* stipulated a list of *Land* and municipal revenue sources that must be included in determining the financial capacity of a *Land*. The Court analysed these provisions thoroughly while considering the individual elements determining the financial capacity of a *Land* and came to the conclusion that the way in which the specified municipal revenue items had been included complied with the requirements of Article 107 (2) of the Basic Law.<sup>93</sup> In the division of expenditure responsibilities between the *Bund* and the *Länder* in Article 104a of the Basic Law, the municipalities are incorporated as part of the *Länder*. The inclusion of part of the revenue of the municipalities in determining the financial capacity of a *Land* thus corresponds with the allocation of expenditure responsibilities to the *Länder*. The Court stated that the horizontal financial equalisation of the *Länder* in terms of Article

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<sup>92</sup> *BVerfGE* 86, 148 216; Häde *DÖV* 46 (1993) 462 – 464; *BVerfGE* 72, 330.

<sup>93</sup> *BVerfGE* 86, 148 225 – 233; Häde *DÖV* 46 (1993) 463.

107 (2) is part of a multiphased system of division of revenue in the whole country, that has as its aim the financial enablement of the *Bund* and the *Länder*, including the municipalities, to fulfil their respective constitutionally allocated obligations. This will then support the respective autonomies of the *Bund* and the *Länder* in terms of the Basic Law.<sup>94</sup>

Although the special needs of individual *Länder* may not be considered in determining the financial capacity of a *Land*, an exception is allowed for the special needs of the three *Länder* with seaports, namely Bremen, Hamburg and Lower Saxony. This is due to the fact that they are responsible for the maintenance and development of those ports while other *Länder* also use it. Article 7 (3) *FAG* made specific provision for the deduction of substantial amounts from the revenue of these *Länder* when determining their financial capacity. This could enable them to qualify for financial equalisation payments. The *Bundesverfassungsgericht* considered these provisions and concluded that they are constitutional as they are regarded as “traditionally part of the financial equalisation arrangements between the *Länder* in German financial constitutional law”.<sup>95</sup>

In determining the equalisation measure as part of the horizontal financial equalisation process, the city-states of Bremen and Hamburg receive special attention by the stipulation of a population valuation of 135%. These two *Länder* argued that this population valuation in Article 9 (2) *FAG* is too low and that their special circumstances as city-states have not been properly accommodated. This is one element of the determination of the equalisation measure that is of particular importance to these *Länder* in view of their status as city-states. The Court rejected their argument and ruled that the provision is constitutional since the Federal Parliament acted within its constitutional mandate and it does not have to give reasons for its determination of a specific population valuation.<sup>96</sup> The *Bundesverfassungsgericht* confirmed its previous judgment (*BVerfGE* 72, 330 401,415) that it was allowed to take the structural peculiarities of these two city-states into account by way of a population valuation. It was the duty of the legislator to

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<sup>94</sup> *BVerfGE* 86, 148 213 – 214.

<sup>95</sup> *BVerfGE* 86, 148 236 – 238; Häde *DÖV* 46 (1993) 465; *BVerfGE* 72, 330 331, 413.

<sup>96</sup> *BVerfGE* 86, 148 238; Häde *DÖV* 46 (1993) 466.

determine the scope of the particular measures that should be based on objectively determined factors. Federal Parliament has done this and based its decision to determine the population valuation for Bremen and Hamburg on 135% on criteria indicated in an expert report of an economical research institute (*Ifo-Institut für Wirtschaftsforschung*) produced on request of the Federal Government.

The question of additional federal grants (*Bundesergänzungszuweisungen*) to Saarland and Bremen, that both experienced serious financial crises, was the second main issue under consideration by the *Bundesverfassungsgericht* in this case. Saarland, a geographically small *Land*, found itself in a financial crisis due to its history. This area changed “ownership” between France and Germany a few times since 1919 and only became a *Land* in the Federal Republic of Germany in 1957.<sup>97</sup> Its economy was essentially developed around coal and steel and therefore during the 1930’s, the arms industry was very important. The economy of Saarland suffered under increasing unemployment and led many people to leave to look for jobs in other parts of Germany. These historical factors compounded to cause the financial crisis experienced by Saarland prior to their application before the *Bundesverfassungsgericht* in *Financial Equalisation Case III*. The position of Bremen was somewhat different, although it was also in a serious financial crisis. Bremen, a city-state, experienced below average growth in own revenue for a number of years, while it had to cope with an increase in expenditure needs caused by the migration of workers from the surrounding *Länder*. This caused a rise in debt and budget deficits and led to the extreme financial situation that Bremen found itself in prior to this case.<sup>98</sup>

The duty to assist each other, a duty that flows from the federal principle, was reconfirmed by the Court, that stated that in case of an extreme financial crisis experienced by a *Land*, it is the duty of the other members of the federal state to support that *Land* in order to stabilise its financial position.<sup>99</sup> Additional federal grants in terms of Article 107 (2) are aimed at providing special assistance to

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<sup>97</sup> *BVerfGE* 86, 148 186.

<sup>98</sup> *BVerfGE* 86, 148 199 – 201.

<sup>99</sup> *BVerfGE* 86, 148 263 – 270; Häde *Finanzausgleich* 248; Häde *DÖV* 46 (1993) 467.

financially weaker *Länder* and cannot replace the transfer payments made in terms of the horizontal financial equalisation process. They should thus always be less than the horizontal equalisation payments. The *Bundesverfassungsgericht* stated that this assistance from the *Bund* should only be given if there is a corresponding duty on the recipient to contribute to the “rescue operation”.<sup>100</sup> Special grants may for example, be allocated by the *Bund* to a *Land* on condition that the specific *Land* develops and implements a financial rehabilitation program.<sup>101</sup>

The last part of Article 107 (2) of the Basic Law makes it possible for the *Bund* to pay additional federal grants to financially weaker *Länder*. Based on this provision, Article 11a *FAG* provided for additional federal grants to be paid to a few *Länder*, including Saarland and Bremen. The Court reiterated that the additional federal grants are complementary payments. It ruled that Article 11a *FAG* was constitutional, but that the additional federal allocations to Bremen should be increased to the same amount as that for Saarland.<sup>102</sup> Bremen, a small *Land* similar to Saarland, was awarded less than Saarland and for 1987 and 1988 it did not get any additional grant. This was ruled to be unconstitutional as *Länder* must be treated even-handedly.<sup>103</sup>

This aspect of the judgment is of particular importance for the new *Länder* that were incorporated into the financial equalisation system from 1 January 1995. The financial situation of these *Länder* was even more serious than that of Bremen and Saarland at the time of this judgment and this implied an increased demand on the financial aid from the *Bund* and from the financially stronger *Länder*.

#### **7 3 4 Financial equalisation case IV (BVerfGE 101, 158 – 11/11/1999)**

In the latest case on financial equalisation the three southern *Länder*, Baden-Württemberg, Bavaria and Hessen, lodged an application to the *Bundesverfassungsgericht* declaring certain provisions of the *Finanzausgleichgesetz*

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<sup>100</sup> BVerfGE 86 148, 268; Häde DÖV 46 (1993) 468.

<sup>101</sup> Häde DÖV 46 (1993) 468.

<sup>102</sup> BVerfGE 86, 148 271 – 276; Häde DÖV 46 (1993) 468.

<sup>103</sup> BVerfGE 86, 148 270 - 271.

of 23 June 1993 unconstitutional.<sup>104</sup> This application was opposed by Bremen, Lower Saxony and Schleswig-Holstein. The three applicants were financially stronger *Länder* and contributors in the horizontal financial equalisation process. One of their main complaints was that the financial equalisation system creates negative incentives and that it results in the unfair treatment of the contributing *Länder*. The applicants argued that the *Finanzausgleichgesetz* of 1993 is unconstitutional on a number of grounds including the following:

- ❖ The population valuation for the city-states is unconstitutional because it does not fit within the constitutional notion of financial capacity of a *Land* and with the inclusion of Berlin, a city-state, it should have been reviewed;<sup>105</sup>
- ❖ The provisions in the *Finanzausgleichgesetz* that describe the calculation of the actual equalisation payments (Article 10 (2) and (4)) are unconstitutional since they contradict the constitutional requirement of a “reasonable equalisation”;<sup>106</sup>
- ❖ The additional federal grants in terms of Article 11 (2) of the *Finanzausgleichgesetz* are unconstitutional since it is in contrast with the prohibition against absolute equalisation;<sup>107</sup> and
- ❖ That the whole financial equalisation process resulted in an absolute equalisation of the financial capacity of the *Länder*, which is unconstitutional, and causes the average financial capacity of the contributing *Länder* to be lower than the average of the receiving *Länder*.<sup>108</sup>

The crucial question before the Court was: does the financial equalisation legislation comply with the requirements in Articles 106 and 107 of the Basic Law to strengthen the constitutional framework for the division of revenue? In answering this question, the Court reviewed the whole financial equalisation system and ruled that the *Finanzausgleichgesetz* is unconstitutional, but that it should be seen as a transitional measure until 1 January 2005.<sup>109</sup>

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<sup>104</sup> BVerfGE 101, 158, a judgment of the Second Senate of 11 November 1999.

<sup>105</sup> BVerfGE 101, 158 A III.3.

<sup>106</sup> BVerfGE 101, 158 para A III.4.

<sup>107</sup> BVerfGE 101, 158 para A III.5.

<sup>108</sup> BVerfGE 101, 158 para A III.9

<sup>109</sup> BVerfGE 101, 158; Spahn “The German Constitutional Court takes on the principle of ‘solidarity’” 2001 (Vol 1 nr 1) *Federations* 1.

The Court stated that the constitutional framework for the division of revenue between the *Bund* and the *Länder* is provided in Articles 106 and 107 of the Basic Law, and that this framework required that federal legislation must strengthen and supplement the constitutional measures. After analysing the whole financial equalisation system and the shortcomings in the *Finanzausgleichgesetz* of 1993, the Court ruled that the Federal Parliament must in particular provide for standards for the division of turnover tax between the *Bund* and the *Länder* (Article 106 (3)), the criteria for the allocation of supplemental shares of the turnover tax to financially weaker *Länder* (Article 107 (1)), standards for the equalisation payments and receipts including the maximum thereof (Article 107 (2)) and standards for the identification and justification of additional federal grants in terms of Article 107 (2) of the Basic Law.<sup>110</sup>

The financial constitution requires in Article 106 (3) and (4) and in Article 107 (2) of the Basic Law a set of standards laid down in legislation. In other words, standards must be determined for the division of revenue or financial equalisation before the practical implementation thereof is effected. The Court ruled that there must be a standards Act that will lay down the mechanisms and standards, followed by a financial equalisation Act, which will provide for the actual division of revenue.<sup>111</sup> While the standards Act should be seen as a more permanent law, the financial equalisation Act must be enacted annually.

The financial constitution binds the standards Act and the financial equalisation Act to the four steps in the financial equalisation process in the following way as expressed by the Court:

- (i) The first step is the division of revenue from turnover tax between the *Bund* and the *Länder* in terms of Article 106 (3) of the Basic Law (vertical financial equalisation). Both levels of government have an equal claim to cover their “necessary expenditures” and the assessment of their needs

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<sup>110</sup> BVerfGE 101, 158 para C I.1.

<sup>111</sup> BVerfGE 101, 158 para C I.1 (c). The standards Act had to be implemented from 1 January 2003 and the new financial equalisation Act at the latest from 1 January 2005.



must result in a fair balance, the prevention of excessive burdens to the taxpayer and ensuring equal living conditions throughout the country. The Court stated that this ideal could be achieved through co-ordinated medium-term financial planning based on objective statistical data.<sup>112</sup> Spahn criticized this view and suggested that it is not possible to compare the necessity of expenditures at the federal level with that at the *Länder* level. It is however possible to make such a comparison, based on objective norms, between the *Länder*, where they have comparable constitutional obligations, for example the provision of education.<sup>113</sup>

- (ii) In the next step, namely the horizontal financial equalisation amongst the *Länder*, the standard is the principle of place of origin of the tax revenue. Constitutionally the measure for the division of revenue from turnover tax is the number of inhabitants, that gives a clear expression of the principle of origin of such revenue, and at least 75% of the *Länder* share of the turnover tax is distributed according to this. A maximum of 25% of the *Länder* share of the turnover tax revenue may be allocated to those financially weaker *Länder* whose financial position is below the *Länder* average. This step concludes the primary allocation of finances to the individual *Länder*.<sup>114</sup>
- (iii) The following step in the horizontal financial equalisation process is the comparison of the financial capacity of individual *Länder* and the reasonable equalisation of the disparities. The Court referred with approval to its previous decisions in this respect and stated clearly that the horizontal financial equalisation should narrow the gap, but should not lead to an absolute equalisation of the financial capacity of the *Länder*.<sup>115</sup> The Court's dilemma here was the balancing of two fundamental principles, namely that of federal solidarity amongst the *Länder* and the

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<sup>112</sup> *BVerfGE* 101, 158 para C I.1 (c).

<sup>113</sup> Spahn 2001 (1) *Federations* 2.

<sup>114</sup> *BVerfGE* 101, 158 para C I.2 (b); *BVerfGE* 72, 330 384.

<sup>115</sup> *BVerfGE* 101, 158 para C I.2 (c) and the Court's reference to *BVerfGE* 1, 117 132; 72, 330 386; 86, 148 215.

autonomy of the *Länder*. The duty to ensure a reasonable equalisation of the financial capacity of the *Länder*, that is an expression of federal solidarity amongst the *Länder*, may not lead to an absolute equalisation and prohibits a reversal of the financial capacity ranking of the *Länder*. It is in particular this issue that was of great concern to the applicants when they argued that the notion of a reasonable equalisation is applied in an incorrect and unconstitutional way in the *Finanzausgleichgesetz*, since it leads to negative incentives and an absolute equalisation of the financial capacity of the *Länder*.<sup>116</sup> The Court concluded that federal solidarity has limits and can reduce differences, but may not lead to a levelling of differences.<sup>117</sup>

- (iv) The last step in the financial equalisation process is the possibility of additional federal grants to financially weaker *Länder* in terms of Article 107 (2) of the Basic Law. It is not a mere extension of the horizontal financial equalisation but should rather be seen as a federal financial intervention that accommodates special needs of individual *Länder* and that can only be for a limited amount and as a transitional measure.<sup>118</sup> It may not be used to assist financially weaker *Länder* to such an extent that it changes the financial capacity ranking of the *Länder*, since that would contradict the prohibition against an absolute equalisation.

The Court ruled that the then existing legislation, namely the *Finanzausgleichgesetz* of 1993, did not comply with the provisions of Articles 106 and 107 since:

- ❖ it was not based on multi-year financial planning,
- ❖ it did not provide objective standards or criteria for the actual financial equalisation, and
- ❖ it led to an absolute equalisation of the financial capacity of the *Länder*.<sup>119</sup>

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<sup>116</sup> *BVerfGE* 101, 158 para A III.4 (a). Negative incentives in this context mean that, due to the particular financial equalisation measures, there is no motivation for the financially weak *Länder* to improve their economic situation and their financial capacity since there is always the possibility of financial assistance in some form or another as part of the financial equalisation system.

<sup>117</sup> *BVerfGE* 101, 158 para C I.2 (c).

<sup>118</sup> *BVerfGE* 101, 158 para C I.2 (d), C II.3 (a); Spahn 2001 (1) *Federations* 2.

<sup>119</sup> *BVerfGE* 101, 158 para C II.1 - 4.

What was envisaged is an overall review of the financial equalisation legislation by the Federal Parliament that will include the adoption of a standards Act as well as an annual financial equalisation Act.<sup>120</sup>

One of the applicants in this case, Bavaria, argued repeatedly for a revision of the financial equalisation system, mainly in view of the increasing lack of incentives to promote better performance.<sup>121</sup> The implementation of the *Finanzausgleichgesetz* of 1993 had the effect that the contributing *Länder* had to make such high contributions that their financial capacity rankings fell below the average of all the *Länder*. This implied that there was no incentive to perform well. This situation led the Court to scrutinise the financial equalisation system, including the elements that contributed to the distorted position where the financially stronger *Länder* eventually found themselves below the average financial capacity due to all the contributions they made to the financially weaker *Länder*. It is evident from the Court's judgment that in addition to the somewhat mechanical approach to remedy the situation, namely, to introduce a standards Act followed by an annual financial equalisation Act, that certain fundamental principles are crucial for the financial relations between the *Bund* and the *Länder* and amongst the *Länder*. These need to be adhered to. These principles are the federal principle or solidarity among the *Länder* (assistance for those in need), the recognition of the financial autonomy of the *Länder* and the prohibition against an absolute equalisation of the financial capacity of the *Länder*. This case can be seen as a milestone in the development of the legislative arrangements regarding the division of funds, or more specifically, the financial equalisation, in Germany.

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<sup>120</sup> The Federal Parliament adopted the two laws required by the *Bundesverfassungsgericht*, viz the *Maßstäbengesetz* on 9 Sept 2001 and the *Finanzausgleichgesetz* on 20 Dec 2001. See discussion under **5 6**; Kämmerer "Maßstäbe für den Bundesfinanzausgleich? – Dramaturgie einer verhinderten Reform" *JuS* 2003, Heft 3 214 215; Kämmerer *Föderalismus als Solidarprinzip* in Vitzthum & Winkelmann (eds) *Bosnien-Herzegovina im Horizont Europas – Demokratische und föderale Elemente der Staatswerdung in Südosteuropa* (2003) 195 212 et seq.

<sup>121</sup> Beierl *Reforming Intergovernmental Fiscal Relations in Germany: The Bavarian Point of View* (2001) 7.

### 7 3 5 Comments

Already in the first dispute regarding the division of revenue before the *Bundesverfassungsgericht*, namely, the *Financial Equalisation Case I*, the Court was quite aware of the separation of powers and its role vis-à-vis that of the legislature, when it stated that a decision about the intensity of the actual horizontal financial equalisation within specific limits is a financial political matter and not a constitutional matter. Therefore, horizontal financial equalisation falls outside the jurisdiction of the *Bundesverfassungsgericht*.<sup>122</sup> It was evident in this case, that the Court has an important role to consider the constitutionality of the financial legislation itself and the constitutionality of the effect of financial equalisation. It appears that the relationship between the *Bundesverfassungsgericht* and the Federal Parliament is a complex or somewhat sensitive one, at least as far as the financial constitution is concerned. Federal Parliament must provide the financial equalisation mechanisms and procedures by way of federal law in order to comply with the requirements of the Basic Law. The *Bundesverfassungsgericht* must interpret such legislation and ensure its compliance with the Basic Law, but it cannot adjudicate financial political questions.

The judgment in *Financial Equalisation Case II* gave more content to the financial constitution of Germany and confirmed the structural framework within which there is scope for political decision-making where the Court would not interfere. The legislature must function within the set limits of this constitutional framework and the *Bundesverfassungsgericht* may test the legislation, for example, financial equalisation legislation, produced by the Federal Parliament.<sup>123</sup> Häde stated in this respect that although financial constitutional arrangements make use of undefined legal terms that create scope for decision-making and evaluation, the legal arrangements thus made by the Federal Parliament are subject to judicial scrutiny in order to adjudicate their compliance with the financial constitutional framework.<sup>124</sup> The relevance of the

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<sup>122</sup> BVerfGE 1, 117 para 50.

<sup>123</sup> Häde *Finanzausgleich* 223.

<sup>124</sup> Häde *Finanzausgleich* 233.

doctrine of separation of powers and the interaction between the *Bundesverfassungsgericht* and the Federal Parliament was reiterated by this judgment.

In its discussion of the working of the financial equalisation system, the *Bundesverfassungsgericht* in *Financial Equalisation Case III* said that horizontal financial equalisation is a separate phase and should receive separate attention when analysing the system. Horizontal financial equalisation is aimed at a reasonable equalisation of the disparity in the financial capacity of the *Länder* that does not imply an absolute financial equalisation, but rather a reasonable closing of the gap of the financial capacity, of the different *Länder*.<sup>125</sup> The duty to make equalisation payments may not lead to a change in the ranking of the *Länder* based on their financial capacity since this will be exceeding the constitutional boundaries of reasonable financial equalisation.<sup>126</sup> This statement by the Court is of great value for the future development of financial equalisation in Germany, since it gives a clear indication that there are limits to horizontal financial equalisation that are of particular relevance to the inclusion of the new *Länder* in the financial equalisation system. The basic point of departure of the *Bundesverfassungsgericht*, is that the financial equalisation process must put the *Bund* and the individual *Länder* in financial positions where they can perform their constitutionally allocated obligations or functions. In doing so, the relative financial autonomy of both the *Bund* and the *Länder* is recognised.<sup>127</sup>

The milestone judgment of the *Bundesverfassungsgericht* in *Financial Equalisation Case IV* is not only important because of its thorough discussion of the various elements of the financial equalisation process, but also because of the clear consideration of the applicable fundamental principles underlying the relations between the *Bund* and the *Länder* that have a direct impact on the financial equalisation process, for example the federal principle contained in Article 20 of the Basic Law. The *Bundesverfassungsgericht* in its analysis of the practical functioning of the financial equalisation system stated clearly that there must be a balance

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<sup>125</sup> BVerfGE 86, 148 214 – 215.

<sup>126</sup> BVerfGE 72, 330 418; BVerfGE 86, 148 250.

<sup>127</sup> Bayerische Staatsministerium der Finanzen *Die Reform des Finanzausgleichs – föderale, ökonomische und verfassungsrechtliche Aspekte* (1998) 23.

between the solidarity duty of the *Länder* and the *Bund*, and the recognition of the financial autonomy of the *Länder*.<sup>128</sup> The *Bundesverfassungsgericht* is aware of the principle of the separation of powers and made it clear in this case that it does not have the final say about financial equalisation and that the Federal Parliament has an important legislative role to play in providing the rules for financial equalisation that must be in accordance with the constitutional framework.<sup>129</sup> The Court, however, perhaps went too far in prescribing to the Federal Parliament what the new legislation should include. In reviewing the financial equalisation legislation the Court found that the Act was unconstitutional, but it went further to prescribe to the Federal Parliament what the new legislation should include.<sup>130</sup> This created an opportunity for some critics to say that the Court did more than merely reviewing an Act, and that it in fact acted as legislator.

#### **7 4 The contribution by the South African Constitutional Court**

South Africa's new democracy is still young and the Constitutional Court was only established in 1994. There is a significant difference in the volume of jurisprudence produced by this Court, in a decade, when compared to that produced by the *Bundesverfassungsgericht* in half a century. There are very few Constitutional Court judgments relating to the central issue of this dissertation, namely the constitutional accommodation of the division of functions and the allocation of financial resources. A number of factors have contributed to this situation, for example, the relatively young age of the Constitutional Court, the fact that the Constitution requires that organs of state involved in intergovernmental disputes should first attempt to resolve such disputes by non-judicial means before approaching a court of law, the political context and the dominant position of the ruling party, as well as the fact that the system of financial equalisation is still relatively new.<sup>131</sup> The absence of a history and tradition of federalism is of particular importance. In South Africa factors such as the long tradition of unitary government before and the conditions caused by apartheid

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<sup>128</sup> *BVerfGE* 101, 158 para A III.4.

<sup>129</sup> *BVerfGE* 101, 158 para D.

<sup>130</sup> See discussion under **7 3 4**.

<sup>131</sup> Sec 41 (3) of the Constitution.

(which now have to be remedied) have steered sensitivities and effort in a different direction.

The judgments of the Constitutional Court can be divided into two broad categories, namely, human rights judgments and judgments relating to constitutional organisational matters that include for, example, intergovernmental disputes over the allocation of functions and the division of finances. Although judgments in the first category primarily concern the relationship between the state and an individual, some of these judgments are relevant for the developing system of financial intergovernmental relations, as will be discussed below. In this analysis of important South African judgments relating to the constitutional accommodation of the division of functions and the allocation of financial resources generally, the selection of cases includes judgments primarily concerned with human rights questions but that have an impact on financial intergovernmental matters.

The fact that the Constitution is the supreme law in South Africa since 1994 has a significant effect on the interpretation of laws. In all the judgments discussed here, the principal of constitutional supremacy was upheld. The literalist approach to interpretation prior to 1994 has made way for a normative approach where effect is given to the values and norms of the Constitution.<sup>132</sup> When interpreting a law a court has to ask ‘What does the Constitution say?’ or ‘How is effect given to the promotion of the spirit, purport and objects of the Bill of Rights?’<sup>133</sup>

The selection of cases below consists of an important judgment regarding the allocation of functions in the Constitution, three judgments that focus on socio-economic issues, that have an impact on financial intergovernmental matters and the only judgment so far that concerns the question regarding the equitable division of revenue raised nationally. It should be noted that the three cases on socio-economic issues were not instituted by provinces. They were brought by individuals.

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<sup>132</sup> Malherbe & Brand *South Africa: Sub-national Constitutional Law* in Alen et al (eds) *Sub-national Constitutional Law* (2001) 42; *S v Makwanyane* 1995 6 BCLR 665 (CC) para 9; *Carmichele v Minister of Safety and Security and Another* 2001 10 BCLR 995 (CC) para 54.

<sup>133</sup> Art 39 (2) of the Constitution.

**7 4 1 *Ex Parte President of the Republic of South Africa: In Re Constitutionality of the Liquor Bill* 2000 1 SA 732 (CC)**

In the first case where the presidential referral procedure was used, the President of the Republic of South Africa referred the Liquor Bill [Bill131B-98] to the Constitutional Court for a decision on its constitutionality.<sup>134</sup> This case followed the end of a protracted dispute between the Western Cape Provincial Government and the national Minister of Trade and Industry concerning the regulation of the liquor industry and the interpretation of the Constitution in this respect. The Minister of Trade and Industry introduced the Liquor Bill, that was new national legislation relating to the liquor industry, in the National Assembly and after passing through all the legislative stages, it was adopted by Parliament. The President had reservations regarding the constitutionality of the Bill, namely, that the provisions relating to the registration for the manufacture, distribution and retail sale of liquor might be in conflict with the strict requirements of a national law in terms of section 44 (2) of the Constitution,<sup>135</sup> and he first referred it back to the National Assembly for reconsideration.<sup>136</sup> No amendments were added to the Bill and the President then referred the Bill to the Constitutional Court for a decision on its constitutionality. The Western Cape Provincial Government contested the constitutionality of the Bill primarily on the ground that it infringed on the exclusive legislative powers of provinces with respect to liquor licenses.<sup>137</sup> The fundamental underlying constitutional questions in this case relate to the division of legislative functions

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<sup>134</sup> In terms of sec 79 (1) the President must refer a Bill back to the National Assembly if he has reservations about the constitutionality of the Bill, and in terms of sec 79 (4), after the reconsideration of the Bill, the President must either assent to and sign the Bill, or if he still has reservations, must refer a Bill to the Constitutional Court for a decision on its constitutionality. See also sec 84 (2) (c) of the Constitution.

<sup>135</sup> Sec 44 (2): “Parliament may intervene, by passing legislation in accordance with sec 76 (1), with regard to a matter falling within a functional area listed in Schedule 5, when it is necessary –

(a) to maintain national security;

(b) to maintain economic unity;

(c) to maintain essential national standards;

(d) to establish minimum standards required for the rendering of services; or

to prevent unreasonable action taken by a province which is prejudicial to the interests of another province or to the country as a whole.”

<sup>136</sup> *Ex Parte President of the RSA: In Re Constitutionality of the Liquor Bill* 2000 1 SA 732 (CC) 738 para 21.

<sup>137</sup> *Liquor Bill-case* para 36 – 37.



between the national and provincial spheres of government and the issue of national legislative intervention in the exclusive legislative jurisdiction of provinces.

According to the Constitutional Court, the organisational framework of the Constitution appears to be designed from a functional perspective based on what is appropriate to each sphere of government, hence the division of concurrent and exclusive ‘functional areas’ of legislative competence.<sup>138</sup> The functional areas central to the matter before the Court are “trade”, “industrial promotion” (concurrent legislative functional areas) and “liquor licenses” (an exclusive provincial legislative functional area). The Court acknowledged the fact that in some cases there can be an overlap between Schedule 4 and 5 functional areas. The Court went further to state that, irrespective of a potential overlap with concurrent functions in this case, a distinct meaning must be given to the exclusive functional area of ‘liquor licenses’.<sup>139</sup> The Court concluded that “liquor licenses”, that are clearly in the realm of an exclusive provincial function, must be interpreted restrictively since it covers a narrower field than the liquor trade, that includes issues such as the manufacture and distribution of liquor.<sup>140</sup> According to the Court, the provincial exclusive competence of “liquor licenses” refers to the licensing of the retail sale of liquor within a province, while the regulation of the liquor trade, that falls within the concurrent field, suggests a national law due to the nature of the issues the law has to deal with, for example, the determination of national economic policies and the promotion of inter-provincial trade.

Even if one could argue that the scope of “liquor licenses” could be extended to include the manufacture and distribution of liquor, there would be sufficient justification for a national law in terms of section 44 (2) of the Constitution. The Court said that the ‘economic unity’ requirement in section 44 (2) (b) had been satisfied since there was a clear need for the maintenance of economic unity in the country as far as it relates to the manufacture and distribution of liquor.<sup>141</sup> The reason being that the liquor industry has national implications that require the setting of

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<sup>138</sup> *Liquor Bill-case* para 51.

<sup>139</sup> *Liquor Bill-case* para 51.

<sup>140</sup> *Liquor Bill-case* para 53 – 58; Malherbe 2000 (63) *THRHR* 331.

<sup>141</sup> *Liquor Bill-case* para 75 – 78; Malherbe 2000 (63) *THRHR* 332.

national common standards for traders and national regulation of the industry so that liquor enterprises can operate countrywide under one license. The Court concluded that a national law regulating the liquor industry, but excluding the issue of liquor licenses for the retail sale of liquor, is constitutionally permitted.<sup>142</sup>

Malherbe, in his discussion of this judgment by the Constitutional Court, criticized the Court for not using the guidelines for testing national intervention in terms of section 44 (2) of the Constitution, which the Court itself laid down in the *First Certification Case*.<sup>143</sup> These guidelines refer to the principles of cooperative government, in particular those listed in section 41 (1) (e), (f) and (g), and the fact that the intervention power is limited and should be used sparingly.<sup>144</sup> Although the criticism might be justified, it is doubtful whether the Court would have reached another decision in the light of the various considerations indicated above that are in favour of a national law.

The allocation of powers and functions to the three spheres of government provides a framework for government that must be explored and enhanced through legislative and executive means, for example, various national and provincial policies, programmes and laws. In doing so, Parliament and the provincial legislatures must adhere to the principle of constitutional supremacy and the principles of cooperative government. The Constitutional Court in this case provided more insight into the constitutional division of powers between the national and provincial spheres of government by giving content to the exclusive provincial legislative matters and the national intervention powers in terms of section 44 (2).<sup>145</sup>

This judgment showed how complex and difficult it often is to define the parameters of national and provincial competences, in particular in relation to concurrent

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<sup>142</sup> *Liquor Bill-case* para 87.

<sup>143</sup> Malherbe 2000 (63) *THRHR* 328 – 329.

<sup>144</sup> Sec 41 (1): “All spheres of government ...must –

- (e) respect the constitutional status, institutions, powers and functions of government in other spheres;
- (f) not assume any power or function except those conferred on them in terms of the Constitution; and
- (g) exercise their powers and perform their functions in a manner that does not encroach on the geographical, functional or institutional integrity of government in another sphere”.

<sup>145</sup> Malherbe 2000 (63) *THRHR* 333 – 334.

functional areas. One may be critical regarding the way the Court defined “liquor licenses” and “trade”, but the fact remains that the Constitution does not define the functional areas listed in Schedules 4 and 5 and when legislation gives content to the functional areas, constitutional supremacy determines that it must be measured against the Constitution.

Although this case did not involve financial intergovernmental issues, it is evident that new legislation in a concurrent functional area could have an impact on the actual division of revenue. This would in particular be the case if such legislation created obligations for provinces. A national Act in a concurrent field, for example, “trade”, that provides for partial or full administration thereof at provincial level implies that provinces must budget for it. The ordinary approach is that funds should follow functions. Provinces could validly argue that this Act creates new obligations for which funding should be allocated by way of an increased equitable share to provinces, or additional allocations to provinces. Giving content to concurrent functional areas could therefore impact on financial intergovernmental relations.

**7 4 2 *Soobramoney v Minister of Health, KwaZulu-Natal* 1997 12 BCLR 1696 (CC)**

This is an important constitutional case since it was one of the first judgments of the Constitutional Court that involved the application of a socio-economic right. Although this study does not focus on human rights issues, this case has relevancy for the dissertation since it relates to the relationship between the judiciary and the legislature and the question concerning judicial review of policy issues, such as how budget allocations are made. The development and adoption of a provincial (or national) budget includes a legal mandate element and policy considerations. The question that must be asked is; How far does the courts’ jurisdiction go regarding financial policy issues?

The primary issue in this case is the application of the right of access to health care services, in particular the right not to be refused emergency medical treatment, as

stipulated in section 27 (3) of the Constitution.<sup>146</sup> The Department of Health in KwaZulu-Natal is responsible for the provision of health care in its provincial hospitals and the appellant in this case requested specialised dialysis treatment for chronic renal failure, that was threatening his life. The hospital refused his application due to a shortage of financial resources and the fact that it had a set policy for the use of dialysis resources. In terms of this a patient only qualified for treatment if he or she is free of significant vascular or cardiac disease. The applicant did not meet this requirement since he had a heart disease.<sup>147</sup> When his application was refused by the particular provincial hospital, the appellant lodged a claim in the High Court, and upon dismissal of such claim, he then approached the Constitutional Court.

The equitable share formula, in terms of which each province's allocation of the provincial share is to be determined, includes a health component.<sup>148</sup> The allocation of funds to different portfolios within a province is done in accordance to the provincial priorities, taking into account conditional grants and the compliance with nationally determined norms and standards. In practical terms, it would mean that it is within the mandate of a provincial government to determine what funding should go to what hospital and for what service within its province.<sup>149</sup> The determination of the specific budget allocations within a province is thus an executive decision that aims to address the needs of that province within its available financial resources. The KwaZulu-Natal Provincial Government in this case had to decide on its overall budget priorities and the funding allocation within the health budget. The Constitutional Court stated in this respect that:

“The provincial administration which is responsible for health services in KwaZulu-Natal has to make decisions about the funding that should be made available for health care and how such funds should be spent. These choices involve difficult decisions to be taken at the political level in fixing the health budget, and at the functional level in deciding upon the priorities to be met. A court will be slow to interfere with rational decisions taken in good faith by

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<sup>146</sup> Sec 27 (3) of the Constitution: “No one may be refused emergency medical treatment.”

<sup>147</sup> *Soobramoney* paras 1 – 5.

<sup>148</sup> See discussion under **6 3 2**.

<sup>149</sup> This is in addition to special grants provided for example to the academic hospitals in Gauteng, Free State, KwaZulu-Natal and the Western Cape.

the political organs and medical authorities whose responsibility it is to deal with such matters.”<sup>150</sup>

The Court concluded that the state’s failure to provide the requested medical treatment to all persons suffering from chronic renal failure did not result in a breach of the obligations in section 27 of the Constitution, because the appellant did not meet all the requirements for patients to receive the particular medical treatment. It was also not proven that the required treatment was “emergency medical treatment” in terms of section 27 (3).<sup>151</sup>

It is evident from this judgment that the allocation of funds to the various budget votes within a provincial (or national) budget is essentially a policy decision that a court would be reluctant to interfere with. The main question in this judgment, however, was the determination of a claim based on section 27 (3) of the Constitution, namely the right not to be refused emergency medical treatment, a question that eventually also related to the allocation of funds. The state, in this case the KwaZulu-Natal Provincial Government, has a constitutional duty to comply with the obligations stated in section 27 of the Constitution<sup>152</sup> while at the same time being responsible for providing funding through its budget for all its executive functions. Du Plessis referred to the dilemma the Constitutional Court faced in this case, namely, to adjudicate the application of a socio-economic right that had budgetary implications, in a situation where a government must make difficult policy decisions regarding the funding of its executive functions.<sup>153</sup> He argued that the Constitutional Court would refrain from “over-constitutionalising issues” and, on the basis of subsidiarity, would not interfere with decisions taken by another organ of state. This, he argued, explains why the Court did not want to interfere with a policy decision by the KwaZulu-Natal Provincial Government. This is a novel way of applying the principle of subsidiarity and is open to criticism. The Court’s reasoning can and should rather be explained by

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<sup>150</sup> *Soobramoney* para 29. See also *Du Plessis v De Klerk* para 180.

<sup>151</sup> *Soobramoney* para 36; Currie & De Waal *Constitutional and Administrative Law* 400.

<sup>152</sup> There is also a general duty on the state, including all spheres of government, in terms of sec 7 (2) of the Constitution to respect, protect, promote and fulfil the rights in the Bill of Rights.

<sup>153</sup> Du Plessis “The South African Constitution as Memory and Promise” 2000 (3) *Stell LR* 385 391. See also Blackbeard “Renal failure – right to haemodialysis denied” 1999 (62) *THRHR* 304 309; Devenish 2003 (66) *THRHR* 97.

applying the separation of powers doctrine. It is not the Court's duty to make such clear policy choices. That falls within the scope of jurisdiction of the executive. However, as the German cases demonstrate, matters relating to financial intergovernmental issues are often more nuanced and the legal and policy considerations are more difficult to separate.

This judgment underlines the complexities involved in determining budget priorities. Provinces cannot only focus on their own policy objectives, but have to take into account nationally determined norms, for example the teacher-learner ratio used to determine funding for schools, and the constitutional requirement to progressively realise socio-economic rights.

### **7 4 3 *Government of the Republic of South Africa v Grootboom* 2000 11 BCLR 1169 (CC)**

In this case a group of squatters initially lodged an application in the Cape High Court seeking an order directing the Oostenberg Municipality to provide basic housing or shelter to them and their children, a claim based on section 26 (1)<sup>154</sup> (the right to have access to adequate housing) and 28 (1) (c)<sup>155</sup> (the right of children to basic nutrition, shelter, basic health care services and social services) of the Constitution.<sup>156</sup> Although this judgment is primarily concerned with a request to provide access to adequate housing or shelter, an important underlying issue is the question of state funding or the financing of basic services.

The Cape High Court confirmed that the right to have access to adequate housing is a socio-economic right that cannot be effected immediately and which is qualified by the requirement that the state must take reasonable measures within its available resources to achieve the progressive realization of this right.<sup>157</sup> The Court followed

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<sup>154</sup> Sec 26:

“(1) Everyone has the right to have access to adequate housing.

(2) The state must take reasonable legislative and other measures, within its available resources, to achieve a progressive realisation of this right.”

<sup>155</sup> Sec 28 (1) (c): “(1) Every child has the right - ...

(c) to basic nutrition, shelter, basic health care services and social services.”

<sup>156</sup> *Grootboom v Oostenberg Municipality and Others* 2000 3 BCLR 277 (C). The Western Cape Provincial Government and the National Government were also respondents in this case.

<sup>157</sup> *Grootboom v Oostenberg* 283.

the approach of the Constitutional Court in *Soobramoney*, namely that the fulfilment of the constitutional obligations relating to socio-economic rights depends on the resources available to the state.<sup>158</sup> This qualification does not mean that the state, be it a national government department, provincial government or municipality, can neglect its constitutional obligations regarding the realization of socio-economic rights because of limited financial resources. The State must make effective use of its available resources and it has to show what steps it took to fulfill its obligations.<sup>159</sup> Furthermore, the conduct of the state must be reasonable. The Cape High Court denied the application based on the right to have access to adequate housing and decided that the respondents complied with the requirements of section 26 (2) of the Constitution since it had a rational housing programme in place to address the pressing need for the provision of basic housing for the poor within the context of scarce financial resources.<sup>160</sup>

The Court then distinguished the applicants' right to have access to adequate housing from the right of children to shelter, that is guaranteed in section 28 (1) (c) of the Constitution. It stated that shelter is a form of temporary lodging and concluded that the state must provide shelter to the children and because the family must be maintained as a unit, the provision of shelter would include the parents of the children.<sup>161</sup> This decision meant that the state had to employ some of its financial resources to provide shelter, albeit temporary form of accommodation, to poor families.

The Constitutional Court reconsidered the matter and reversed the Cape High Court's decision. After a thorough analysis of the socio-economic rights in sections 26 and 28 of the Constitution, the Court concluded that neither of these sections entitles a person to claim shelter or housing immediately on demand. It stated that children's right to

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<sup>158</sup> *Grootboom v Oostenberg* 283.

<sup>159</sup> *Grootboom v Oostenberg* 286.

<sup>160</sup> *Grootboom v Oostenberg* 287.

<sup>161</sup> *Grootboom v Oostenberg* 288 – 289; Du Plessis "The South African Constitution" 224.

shelter does not create an obligation on the state where the children are in the care of their parents or families.<sup>162</sup> There is however, a duty on government to develop and implement a coordinated programme aimed at meeting its obligations in terms of section 26. This means that the state must take positive action to develop, fund and implement a programme to provide relief to the extremely poor and homeless people. This duty is qualified by the requirement that the measures must be reasonable, it must be aimed at the progressive realization of the right and must be done within the available resources of the state.<sup>163</sup> In this case, the Cape Metropolitan Council (under which the Oostenberg Municipality resorted) failed to make adequate provision to achieve the progressive realization of the right of access to housing, since it did not provide for temporary shelter for homeless people.<sup>164</sup>

Any programme established to provide housing or temporary shelter obviously requires funding. Giving effect to the right to have access to adequate housing in section 26 (1) of the Constitution thus has a direct impact on the budgets of the responsible government entities. Already in *Soobramoney*, the Court emphasized the fact that financial resources are scarce and that governments face difficult choices when determining budget priorities with limited available finances.<sup>165</sup> The qualification “within its available resources” in section 26 (2) means that the obligation does not require the state to do more than what its available resources would allow.<sup>166</sup> The availability of resources determines the way in which effect is given to the progressive realization of a socio-economic right. Local government and each province must utilize its respective equitable shares of the revenue raised

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<sup>162</sup> *Government of the RSA v Grootboom* 2000 11 BCLR 1169 (CC) para 77; Sloth-Nielsen “The child’s right to social services, the right to social security, and primary prevention of child abuse: some conclusions in the aftermath of *Grootboom*” 2001 (17) *SAJHR* 210 224.

<sup>163</sup> *Government of the RSA v Grootboom* para 38 – 46.

<sup>164</sup> *Government of the RSA v Grootboom* para 44, 93 – 99; Currie & De Waal *Constitutional and Administrative Law* 398 – 399.

<sup>165</sup> *Soobramoney* para 11.

<sup>166</sup> *Government of the RSA v Grootboom* para 46. See Streak & Kgamphe “Government’s recent performance in budgeting for the child’s right to social assistance in South Africa” in *Budget Brief* nr 107 (June 2002) for a discussion on budgeting for social assistance to children based on the Constitutional Court’s judgment in *Grootboom*.



nationally to inter alia provide basic services.<sup>167</sup> Provision of basic housing to the poor or unemployed is an example of basic services that provinces and municipalities are responsible for.

This judgment of the Constitutional Court has an important implication for government, namely that when designing the budget, the setting of priorities must take into account the requirements of the provisions on socio-economic rights in the Constitution. This implies that government departments and municipalities responsible for the provision of basic services, such as housing, water and health care, should include in their strategic plans and budgets comprehensive programmes within their available resources aimed at progressively realizing the socio-economic rights laid down in the Constitution.

Sloth-Nielsen said that this was an important judgment that made a positive contribution to the fulfilment of socio-economic rights.<sup>168</sup> Another commentator, Bilchitz, criticized the Constitutional Court's judgment because it failed to interpret the right of access to adequate housing as including a minimum core content.<sup>169</sup> The Constitutional Court did not follow the minimum core approach, but instead considered the reasonableness of the state's programmes. The Court's approach is supported by authors such as Currie & De Waal, who stated that the requirement of reasonableness includes the opportunity for the Court to get a progress report from the executive on the measures it has designed, funded and implemented in an effort to achieve the progressive realization of the right.<sup>170</sup> The achievement of this right cannot be seen as a once off event, but requires appropriate measures and funding on an ongoing basis.<sup>171</sup>

This judgment reiterates the difficulty that governments face when they have to set budget priorities with limited funding available. It also gives some guidance

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<sup>167</sup> Sec 227 (1) of the Constitution.

<sup>168</sup> Sloth-Nielsen 2001 (17) *SAJHR* 224.

<sup>169</sup> Bilchitz "Giving socio-economic rights teeth: the minimum core and its importance" 2002 (119) *SALJ* 484.

<sup>170</sup> Currie & De Waal *Constitutional and Administrative Law* 399; Sloth-Nielsen 2001 (17) *SAJHR* 226.

<sup>171</sup> *Jaftha v Schoeman and Others; Van Rooyen v Stoltz and Others* 2003 10 BCLR 1149 (C) par 39.

regarding measuring “the progressive realization” of a socio-economic right, an issue that has a direct impact on the equitable division of revenue since it places a duty on government to budget for it.

**7 4 4 *Minister of Health and Others v Treatment Action Campaign and Others (No 2)* 2002 5 SA 721 (CC)**

The latest case before the Constitutional Court that concerned the right of access to public health care services in terms of section 27 (1) and a child’s right to basic health care services in terms of section 28 (1) (c) of the Constitution is the case of the *Minister of Health and Others v Treatment Action Campaign and Others (No 2)* 2002 5 SA 721 (CC). The case started in the Pretoria High Court as an application by the Treatment Action Campaign (TAC) and a number of civil society associations to order the government (the national Minister of Health and all the provincial governments except the Western Cape) to make an antiretroviral drug called Nevirapin available in the public health sector for the treatment of HIV-positive mothers and pregnant women in order to reduce the risk of transmission of the disease to their babies. The Western Cape Provincial Government was the only government in South Africa that, before the start of this case, had a treatment programme in place for pregnant women, mothers and their babies to combat mother-to-child transmission of HIV. The government (national Minister of Health and eight provinces) appealed to the Constitutional Court against the orders made in the High Court that directed them to provide the specific treatment requested by the applicants and to provide an effective comprehensive national programme to prevent or reduce the mother-to-child transmission of HIV. The policy of the national Minister of Health at the time was to allow the provision of Nevirapin only at certain test sites at various locations in South Africa.<sup>172</sup> An important constitutional issue before the Constitutional Court was the potential impact that the enforcement of a socio-economic right might have on the principle of separation of powers.

The scope of the HIV/AIDS pandemic in South Africa and the need for substantive measures to combat the spread of the disease is central to this case. That all spheres

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<sup>172</sup> *Min of Health v TAC(No 2)* paras 10 – 15.

of government have a role to play in addressing this issue is not questioned. However, the scope of responsibility of government in this respect, with particular reference to the constitutional obligations in sections 27 and 28 of the Constitution, was the focus of this case before the Constitutional Court. The main issue was whether government is constitutionally obliged to adopt and implement a comprehensive and progressive programme for the prevention of mother-to-child transmission of HIV throughout the country.<sup>173</sup>

The Court was again faced with the question of the enforcement of a socio-economic right and the financial implications thereof. It upheld its previous decisions in *Soobramoney* and *Grootboom* and confirmed that the state has an obligation to give effect to socio-economic rights. The question was whether the government adopted reasonable measures to give effect to the right of access to health care services, with particular reference to HIV-positive mothers and their newborn babies. It was not the Court's role to determine the spending priorities of governments when addressing various socio-economic needs, but the Court did have an important role to play in evaluating the reasonableness of the measures, or programmes, adopted by the state to fulfil its constitutional obligations.<sup>174</sup> Van Wyk commented that the separation of powers is given effect to, when a court has to assess the reasonableness of the government's policy and programmes to give effect to the right of access to health care services.<sup>175</sup> The court does not assume the role of the executive, but has to measure the policy and programmes of government against the constitutional requirements. If it is not reasonable and does therefore not comply with the provisions in section 27 of the Constitution, the court can make an order that would ensure effective relief for the applicants, even if it affects government policy or legislation.<sup>176</sup> The Court referred to its decision in *Grootboom* and stated that in order to be reasonable, a programme for the realization of socio-economic rights must be

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<sup>173</sup> *Min of Health v TAC (No 2)* para 5.

<sup>174</sup> *Min of Health v TAC (No 2)* paras 35 – 39.

<sup>175</sup> Van Wyk "The enforcement of the right of access to health care in the context of HIV/AIDS and its impact on the separation of powers" 2003 (66) *THRHR* 389 400.

<sup>176</sup> *Min of Health v TAC (No 2)* para 106; Van Wyk 2003 (66) *THRHR* 400.

balanced, flexible, give attention to short, medium and long term needs and may not exclude any significant part of the community.<sup>177</sup>

The Constitutional Court found that the cost of providing Nevirapin to mother and child where counselling and testing facilities exist, was within the financial means of the state and could thus be provided.<sup>178</sup> It was further held that sections 27 (1) and (2) of the Constitution warrant a comprehensive and co-ordinated programme by government to realise progressively the rights of pregnant women, HIV-positive mothers and their babies to have access to health care services to combat mother-to-child transmission of HIV. The government policy of a limited treatment programme at test sites discriminated against patients, who were not close to the test sites, and was not reasonable and therefore did not meet the constitutional standard.<sup>179</sup> The Court followed the approach in *Soobramoney* and *Grootboom* to assess the reasonableness of the government policy in giving effect to the right of access to health care services, and in doing so contributed to a better understanding of the scope of the courts' jurisdiction vis-à-vis the constitutionality of policies by the executive.

The Constitutional Court ordered the government to remove the restrictions on the provision of Nevirapin at public hospitals and clinics and to develop and implement a comprehensive treatment program at public hospitals and clinics throughout the country. This must be done progressively and within the available resources, that is, in accordance with reasonable measures and with the shortest possible delay.<sup>180</sup>

An important result of this judgment is that the progressive realisation of socio-economic rights within the available financial resources of government implies that government must provide a reasonable policy and programme to give effect to socio-economic rights, and that the courts can assess the reasonableness of the measures designed and adopted by government. Although such a review by the courts can have an impact on a government's budget, Van Wyk states correctly that a court's role is

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<sup>177</sup> *Min of Health v TAC*(No 2) paras 68 and 100.

<sup>178</sup> *Min of Health v TAC* (No 2) para 73.

<sup>179</sup> *Min of Health v TAC* (No 2) paras 78 – 80.

<sup>180</sup> *Min of Health v TAC*(No 2) para 135; Van Wyk 2003 (66) *THRHR* 404.

not to reprioritise budget allocations.<sup>181</sup> The Constitutional Court was quite clear in this respect, when it confirmed that a court is not equipped to decide on the most effective allocation of public revenue in a government's budget.<sup>182</sup> That is the task of the executive, in particular the Minister of Finance and his nine provincial counterparts.

As far as government funding for the fight against HIV/AIDS is concerned, it should be noted that as part of a long term strategy, special attention is given to the prevention and combating of HIV/AIDS in the Division of Revenue Act 5 of 2002 and in 2003 and 2004 through the allocation of additional conditional grants to provinces.<sup>183</sup>

#### ***7 4 5 Uthukela District Municipality and Others v The President of the RSA and Others 2002 11 BCLR 1220 (CC)***

The only case so far before the Constitutional Court concerning a dispute between organs of state about the division of revenue in terms of section 214 of the Constitution, is the case of *Uthukela District Municipality and Others v The President of the Republic of South Africa and Others* 2002 11 BCLR 1220 (CC). The three applicants are Category C municipalities (district municipalities) in KwaZulu-Natal and amongst the respondents are the Minister of Finance (second respondent) and the Minister of Provincial and Local Government (third respondent).<sup>184</sup>

The Division of Revenue Act 1 of 2001 ("the 2001 Act") provides inter alia in section 3 (1) for the division of revenue raised nationally among the national, provincial and local spheres of government. In section 5 (1) provision is made for the allocation of the local government equitable share to individual Category A and B municipalities, but no allocation is made to Category C municipalities.<sup>185</sup> Uthukela District

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<sup>181</sup> Van Wyk 2003 (66) *THRHR* 405.

<sup>182</sup> *Min of Health v TAC (No 2)* para 37.

<sup>183</sup> Schedule 5 of Act 7 of 2003; Schedule 4 of Act 5 of 2002; National Treasury *Budget Review 2004* 264; National Treasury *Budget Review 2002* 263 – 264.

<sup>184</sup> Sec 155 (1) of the Constitution determines that local government is structured as Category A, (metropolitan municipalities), Category B (local municipalities) and Category C municipalities (district municipalities).

<sup>185</sup> Sec 5 (1) of the 2001 Act provides as follows:

Municipality and the other two applicants did not receive an allocation in terms of the 2001 Act and therefore lodged an application to the Natal High Court, that gave an order declaring section 5 (1) of the 2001 Act unconstitutional. The Constitutional Court has to confirm any High Court order of unconstitutionality of an Act of Parliament;<sup>186</sup> hence this application, that focuses on the entitlement of Category C municipalities to part of the equitable share of revenue raised nationally.

The question before the Court was whether category C (district) municipalities are entitled to an equitable share of revenue raised nationally. In a settlement agreement that was concluded during the proceedings before the Constitutional Court, it was agreed that the first three respondents would pay to each of the three applicants a specified amount and that the application for payment of the applicants' 2001 equitable share be withdrawn.<sup>187</sup> In view of this settlement, which satisfied the applicants' immediate financial needs, the Constitutional Court did not fully address the important constitutional questions underlying the applicants' request, namely the issue of the constitutionality of the 2001 Act and the question of whether Category C municipalities had a right to an equitable share of revenue raised nationally. It should be noted that at the time of hearing this application in the Constitutional Court, the 2001 Act had been repealed by the Division of Revenue Act 5 of 2002 ("the 2002 Act"). This made the question regarding the confirmation of the High Court order academic. The Constitutional Court then decided that in the absence of full argument on the constitutional issues concerned and in view of the settlement reached and because of the repeal of the 2001 Act, that it should not entertain the question concerning confirmation of the High Court order.<sup>188</sup>

There was a further issue raised by the Constitutional Court, namely that the municipalities concerned and the Minister of Finance and other interested parties, should first have attempted to resolve this intergovernmental dispute before bringing

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"The national accounting officer responsible for local government must determine the allocation for each category A and B municipality in respect of the equitable share for the local sphere of government set out in Schedule 1 for the financial year and such determination must be published by the Minister in a Gazette by 15 May 2001."

<sup>186</sup> Sec 172 (2) (a) of the Constitution.

<sup>187</sup> *Uthukela District Municipality* para 10.

<sup>188</sup> *Uthukela District Municipality* para 25.

it to Court.<sup>189</sup> The Constitution is quite clear that all organs of state in an intergovernmental dispute must make a reasonable effort to resolve such dispute by means other than litigation and must exhaust all other remedies before approaching a court.<sup>190</sup> The Intergovernmental Fiscal Relations Act 97 of 1997 provides for two intergovernmental bodies, namely the Budget Council and the Budget Forum (where local government is also represented), where discussions on fiscal, budgetary and financial matters take place. Provision is further made that organs of state should make every effort, including using intergovernmental bodies such as the Budget Forum, to settle any disputes regarding allocations provided for in that Act, before going to court.<sup>191</sup> In accordance with the Constitutional Court's view, the applicants should have attempted, in the interest of cooperative government, to resolve this dispute within the Budget Forum.

It was to the benefit of the applicants to reach the settlement they reached, because they received financial much needed allocations from the national government in terms of the settlement. These allocations were needed to fulfil their functions as district municipalities. From a constitutional law perspective it is, however, a pity that full argument was not heard on the constitutional questions and that the Court did not make a ruling on the question of the right of district municipalities to an equitable share of revenue raised nationally. It would have been the first judgment that considered the scope of section 214 and section 227 of the Constitution together with the provisions of the relevant Division of Revenue Act and would have contributed to a better understanding of the constitutional arrangements pertaining to financial intergovernmental relations.<sup>192</sup> It is apparent from the judgment that an aggrieved party, such as the Uthukela District Municipality, should utilise intergovernmental mechanisms, like the Budget Forum, to try and resolve its dispute.

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<sup>189</sup> *Uthukela District Municipality* para 23 – 25.

<sup>190</sup> Sec 41 (3) of the Constitution.

<sup>191</sup> *Uthukela District Municipality* para 21 – 23.

<sup>192</sup> Since the time of this judgment until finalising this dissertation no other similar cases were heard by the Constitutional Court.

## 7 4 6 Comments

There are a number of reasons why the Constitutional Court has so far not given any judgments regarding the substance of the equitable division of revenue. The fact that there is a constitutional imperative that all other remedies should be utilised before intergovernmental disputes are brought before a court certainly has a suppressing effect on potential Constitutional Court judgments in this field, but the most important reason is perhaps that the political stage of South Africa is dominated by a single ruling party. This limits the possibility of legal disputes regarding the division of revenue and of the Constitutional Court having to rule on such matters.

The value of the decision of the Constitutional Court in the *Liquor Bill-case* lies primarily in the fact that the Court made a thorough analysis of the constitutional demarcation of the legislative functions between the national and provincial spheres of government. This was a particularly difficult matter because of the fact that the Bill contained provisions that fell within both the concurrent and exclusive provincial legislative areas. The division of functions was one of the most contentious and difficult matters during the constitutional negotiations and during the certification process before the Constitutional Court. This judgment is therefore important for the further development of the South African constitutional system and for a better understanding of the Constitution, since it provides meaning to the exclusive provincial legislative powers and it gives some guidance regarding the understanding of national intervention powers in terms of section 44 (2) of the Constitution.

The fact that the Constitutional Court confirmed that 'liquor licenses' is an exclusive provincial legislative competence is also significant for the subject of this dissertation, since it establishes a potential source of provincial own revenue, something provinces are in need of.

Although it was a case about socio-economic rights, one of the underlying issues in *Soobramoney* was the question regarding the scope of the Constitutional Court's review power over policy decisions by the executive. Both the High Court and the Constitutional Court held in this case that the decision by the KwaZulu-Natal Health Department to refuse Soobramoney's claim for dialysis treatment was essentially a



political one and that they would not interfere with that decision. Van Wyk commented that the Court's review of the decision by the KwaZulu-Natal Provincial Government was correctly done since it weighed and balanced the financial constraints of the Provincial Government, the rights of other patients and Soobramoney's right to health care before finding that the decision by the Provincial Government was under the particular circumstances a reasonable decision.<sup>193</sup> The Constitutional Court did not analyse the different policy options or the way funds were allocated, as they would have been interfering in the policy decisions that the executive make and would therefore have been unconstitutional.<sup>194</sup> In this manner the principal of separation of powers was adhered to.

The Constitutional Court in *Grootboom* gave a clear indication of how effect should be given to the constitutional requirements regarding the progressive realisation of socio-economic rights, but at the same time acknowledged that they are very difficult to enforce and that one will have to assess it on a case by case basis.<sup>195</sup> Again, as in *Soobramoney*, the Court based its decision on the test of the reasonableness of the measures taken by government to give effect to the applicable constitutional requirements. The relevance of these judgments, as well as the Constitutional Court's judgment in *Minister of Health v TAC (No 2)*, for this study, lies in the fact that governments in all three spheres must, amongst other policy considerations, take into account the requirements relating to the fulfilment of socio-economic rights when determining their budget priorities. They in fact have a specific duty to progressively give effect to the socio-economic rights contained in the Constitution.<sup>196</sup>

In the only case so far that concerns the division of revenue in terms of section 214 of the Constitution, namely *Uthukela District Municipality v President of the RSA*, the Constitutional Court did not discuss the scope of section 214 and section 227 of the Constitution and the consequential legislation, namely the Division of Revenue Act, as a settlement between the parties was reached prior to full argument and because of

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<sup>193</sup> Van Wyk 2003 (66) *THRHR* 398.

<sup>194</sup> *Ex parte: President of the RSA NO and Others* 1999 8 BCLR 885 (T) 893; *Du Plessis v De Klerk* 1996 3 SA 850 (CC) para 180.

<sup>195</sup> *Government of the RSA v Grootboom* paras 32 – 38; Van Wyk 2003 (66) *THRHR* 397.

<sup>196</sup> De Waal, Currie & Erasmus *The Bill of Rights Handbook* (1999) 41.

the fact that the 2001 Act, that was in question, had been repealed.<sup>197</sup> No real insight was thus gained regarding the scope of these constitutional provisions governing the financial intergovernmental relations.

In the recent cases of *Khosa and Others v Minister of Social Development and Others* and *Mahlaule and Another v Minister of Social Development and Others* 2004 6 BCLR 569 (CC), the Constitutional Court gave further direction to the state's responsibility to progressively give effect to socio-economic rights. In these cases the right of access to social security in terms of section 27 (1) (c) of the Constitution was highlighted.<sup>198</sup> Mokgoro J, in a majority judgment, stated that when assessing the reasonableness of legislative or other measures taken by the state, the desirability of the specific measures or the prioritisation of expenditure obligations would not be questioned by a court.<sup>199</sup> In assessing the reasonableness of the legislation, the Court must inter alia consider the purpose of the social security provisions and the impact it has on other intersecting rights. The Constitutional Court concluded that the specific legislative provisions governing the payment of social security grants were not reasonable since they excluded permanent residents from the application of the law and this affected their dignity and equality.<sup>200</sup> The right to have access to social security is awarded to everyone and not only to citizens.

This judgment demonstrates an important feature of the South African cases, namely how obligations with respect to socio-economic rights impact on financial intergovernmental relations, in particular the vertical division of revenue. It places an additional financial obligation, the size of which is unclear, on government to make sufficient financial provision for the payment of social security grants to permanent residents.

This judgment contributed to a better understanding of the implications of implementing socio-economic rights. In particular, it gave further guidance to

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<sup>197</sup> *Uthukela District Municipality v The President of the RSA*

<sup>198</sup> 2004 6 BCLR 569 (CC).

<sup>199</sup> *Khosa v Min of Social Services* paras 48 – 49.

<sup>200</sup> *Khosa v Min of Social Services* paras 79 – 85, 98.

government regarding the way in which the “progressive realisation” of such rights should be addressed in practice.

## 7 5 Conclusion

The judgments discussed in this chapter underline the important role of the *Bundesverfassungsgericht* and the Constitutional Court in upholding the principle of constitutional supremacy and confirms the principle of separation of powers and the necessary interplay between these two fundamental constitutional principles.<sup>201</sup> In a recent judgment, the Constitutional Court very aptly described this position as follows:

“The Constitution requires the courts to ensure that all branches of government act within the law. The three branches of government are indeed partners in upholding the supremacy of the Constitution and the rule of law.”<sup>202</sup>

In both Germany and South Africa, the respective constitutional provisions relating to the allocation of functions and the division of finances, provide a framework that must be complemented by additional legislation. Any such legislation must obviously comply with the relevant constitutional provisions and in this respect it is the role of the *Bundesverfassungsgericht* and the Constitutional Court respectively, to test the legislation against the constitutional provisions and, in doing so, give effect to the principle of supremacy of the constitution. The *Bundesverfassungsgericht* was, since its inception in 1951, instrumental at crucial times in Germany’s constitutional history and has given guidance to the further development of the constitutional system, in particular as far as it relates to the allocation of functions and the financial constitution. This court continues to play this role, as is evident in the latest case on financial equalisation, namely, *Financial equalisation case IV*.<sup>203</sup> The *Bundesverfassungsgericht* gave clear direction to the Federal Parliament in this case about the legislation to be developed in terms of section 106 and 107 of the Basic

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<sup>201</sup> Schlüter 1998 (2) TSAR 284; Starck *Constitutional Interpretation* 52.

<sup>202</sup> *President of the RSA v United Democratic Movement* 2003 1 SA 472 (CC) para 25.

<sup>203</sup> BVerfGE 101, 158 – 11/11/1999.

Law, while at the same time recognising the scope of the legislature's function to give content to these constitutional provisions. This confirms the principle of separation of powers and the important place of the *Bundesverfassungsgericht* in the system of checks and balances.

The Constitutional Court, which was established in 1994, has also left its mark on the shaping of South Africa's new constitutional order. It has, however, played a limited role in the area of jurisprudence relating to the constitutional accommodation of the division of functions and the allocation of financial resources to the various spheres of government. This could be ascribed to a combination of the following factors:

1. The dominating role that human rights jurisprudence has occupied since 1994;
2. A growing human rights culture in South Africa;
3. The fact that an important part of the South African constitutional philosophy, as described in Chapter 3 of the Constitution, is that intergovernmental disputes should first be resolved by means other than litigation and that the Constitutional Court should only be the final arbiter. South Africa has its own political agenda and priorities. The need to address the legacy of apartheid and to relieve poverty will not only determine spending priorities, it will also influence decisions on constitutional litigation;
4. The particular South African political context which is characterised by the dominance of the ruling party and the absence of political contest between provinces *inter se* and between provinces and the national government;
5. The fact that the new South African constitutional order has been in place for only one decade and the time it has taken the new institutions to be properly established and new legislation and intergovernmental relations, mechanisms and structures to be developed;
6. The absence of a history of federalism. The provinces are not rooted in a long history of constitutional and political legitimacy and popular sentiment. They are part of a recent political settlement and a compromise formula, not the source of major contestation; and

7. Since the adoption of the South African Constitution the “federal” issue has declined in importance and there are new concerns about effective governance and fiscal and financial discipline.

It is evident from all the German judgments discussed in this Chapter that there is an important difference in the constitutional philosophy in Germany compared to that in South Africa, namely, that contrary to the South African situation, there is no explicit provision in the Basic Law that requires organs of state to first try and resolve their disputes out of court before they approach the *Bundesverfassungsgericht*. There are thus, at least as far as the Basic Law is concerned, no obstacles in the way of any organ of state to take an intergovernmental dispute to the *Bundesverfassungsgericht*.

An important difference in the approach of the two constitutional courts is the role of *Bundestreue*. The *Bundesverfassungsgericht* has been quite active over the years in developing specific obligations of the *Bund* and the *Länder* respectively based on the principle of *Bundestreue*, that in turn relates to the federal state principle contained in the Basic Law.<sup>204</sup> The Constitutional Court, on the other hand, has so far not been that creative, for the reasons indicated above. In the absence of a Constitutional Court judgment about the equitable division of revenue between the spheres of government, one can only speculate about how far the Constitutional Court would act to give more content to the financial equalisation provisions. It is likely that the Constitutional Court will follow its basic philosophical view and take a conservative approach to questions relating to the division of functions and questions regarding financial equalisation. If there were competition between the provinces and the national government, it is likely that the Court would have had to adjudicate more disputes about the division of revenue. In these cases constitutional concepts such as “co-operative government” and “equitable division of revenue” would perhaps be further developed.

It is further evident that the fundamental constitutional principles of a federal, democratic and social state are overarching constitutional principles that guide the interpretation of intergovernmental and structural issues and human rights issues.

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<sup>204</sup> Kommers *Constitutional Jurisprudence* 72 – 75.

Starck commented in this respect that in interpreting these structural principles of the Basic Law, one must have regard for the expression of these principles in the constitutional norms of organisation, competence and procedure.<sup>205</sup> When, for example, the division of legislative functions or the allocation of funds in terms of financial equalisation legislation is the subject matter of a dispute before the *Bundesverfassungsgericht*, the fundamental principles of a democratic and social federal state would be interpreted as they find expression in the relevant provisions on organisation, competence and procedure. In all four of the judgments discussed here the Court followed this approach and tested the applicable financial legislation and Articles 106 and 107 of the Basic Law against the fundamental principles contained in other parts of the Basic Law, for example, the federal principle in Article 20. It is therefore clear that the fundamental principles in the Basic Law indeed play a key role in understanding and giving effect to the constitutional provisions relating to the allocation of functions and division of revenue to the *Bund* and the *Länder* respectively.

The application of the federal principle, that describes the nature of the constitutional system in the financial equalisation process was confirmed in all four of the judgments of the *Bundesverfassungsgericht* discussed here. The Court stated, in *Financial Equalisation Case I* and confirmed in subsequent judgments, that the financially stronger *Länder* have a duty to support the financially weaker *Länder* in such a way that it does not lead to a total equalisation of their financial positions.<sup>206</sup> Von Münch commented that financial equalisation is an expression of federal solidarity.<sup>207</sup> This is not only important for the functioning of the financial equalisation system in Germany, but is also of value to the financial equalisation system in South Africa. ‘Federal solidarity’ implies that the various governments should assist one another, and in particular in cases of financial need that the richer governments (*Bund* and *Länder*) should support the financially weaker *Länder*.

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<sup>205</sup> Starck *Constitutional Interpretation* 65.

<sup>206</sup> *BVerfGE* 1, 117 para 44.

<sup>207</sup> Von Münch *GG Komm* 842.

In South Africa with its huge economic disparities between the different provinces, the application of this notion would mean that provinces must be able to support each other financially. This implies that provinces should have more own sources of revenue that would enable them to fulfil this supportive role to assist one another. Currently it is only the national government that assists provinces in financial need and there is no question of solidarity. If cooperative government is further developed, especially on a horizontal level in South Africa, the notion of ‘federal solidarity’ would be an element to be considered.

Another important aspect of the German judgments discussed above, is the statement that the financial equalisation system is a multiphased system of division of revenue throughout the country that aims to enable the *Bund* and the *Länder* to fund their respective constitutional obligations.<sup>208</sup> In other words, the financial resources must be allocated in such a way that the respective governments can each play a constructive role in fulfilling their respective constitutional mandates. The South African Constitution echoes this view by the inclusion of a provision relating to the funding for provincial and local governments, namely section 227 (1) that refers to the entitlement of local government and each province “to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it”. This matter was referred to in *Uthukela District Municipality*, but in view of the out of court settlement reached there was, unfortunately not analysed.<sup>209</sup>

The recent reconsideration of the functioning of the financial equalisation system in Germany, after the judgment of the *Bundesverfassungsgericht* in *Financial Equalisation Case IV*, is not only a significant milestone, but also perhaps a turning point in the development of the German financial equalisation system. In this respect it should firstly be noted that particular provisions enshrined in the Basic Law play a key role and must be adhered to, namely, the federal principle or solidarity amongst the *Länder* (Article 20), the recognition of the financial autonomy of the *Länder* (Article 104a and 109) and the prohibition against an absolute equalisation of the financial capacity of the *Länder* (Article 107 (2)). In providing the constitutionally

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<sup>208</sup> BVerfGE 86, 148 213.

<sup>209</sup> *Uthukela District Municipality* para 2 – 3.

required legislation for financial equalisation, the Federal Parliament must give effect to these principles in a balanced way. If too much emphasis is placed on either solidarity amongst the *Länder* or the recognition of their financial autonomy, it will have negative effects on the financial equalisation system and will then not be in compliance with the Basic Law. It is thus important in a decentralised system of government to have clear principles contained in the constitution guiding the development of legislation for financial equalisation, and that the notions of financial autonomy and solidarity or cohesion amongst the provinces should be accommodated in a balanced way. Such clear principles are lacking in the case of South Africa, and could have been useful in the further development of financial intergovernmental relations if they were included in the Constitution.

It is evident from all the judgments of the Constitutional Court discussed here, that it either expressly or by implication confirmed the principle of constitutional supremacy when it tested both executive decisions and legislation against the provisions of the Constitution. The *Liquor Bill-case* perhaps provided the clearest reference to this when the Court described the division of functions in the new constitutional order.<sup>210</sup> The three judgments on socio-economic rights highlighted the dire socio-economic needs of a large section of society in South Africa as well as the difficulties facing government in addressing these needs. The Constitutional Court further made it clear in these three judgments that the national government, each province and the municipalities (where applicable) should accept their financial responsibility to address the socio-economic rights but it was acknowledged that these rights cannot be immediately fulfilled.

The sometimes complex nature of the relationship between the judiciary, in particular the Constitutional Court and *Bundesverfassungsgericht* respectively, and the executive and legislative arms of government was highlighted in quite a number of the judgments discussed here. It was the symbiotic relationship between the principle

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<sup>210</sup> *Liquor Bill-case* 755.



of constitutional supremacy and the separation of powers, as Starck described it that was demonstrated in these judgments.<sup>211</sup>

From this analysis concerning some of the key judgments in both Germany and South Africa regarding the constitutional accommodation of the allocation of functions and division of financial resources, it is evident that constitutional provisions should be sufficiently clear and should include specific fundamental principles to guide the further development of applicable legislation, including legislation on financial equalisation. The *Bundesverfassungsgericht* and the Constitutional Court are key institutions in this respect, although they are not the developers of policy or legislation.

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<sup>211</sup> Starck *Constitutional Interpretation* 52; *UDM v President of the RSA (No 2)* para 115.

## **8 Conclusion**

### **8 1 Constitutional accommodation of financial intergovernmental relations**

#### **8 1 1 Impact of economic, political and other considerations**

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## **Chapter 8 Conclusion**

### **8 1 Constitutional accommodation of financial intergovernmental relations**

#### **8 1 1 Impact of economic, political and other considerations**

The main question posed in this dissertation is: how does the constitutional arrangement regarding the distribution of financial resources and constitutional obligations to the various spheres of government in Germany compare with that in South Africa? In other words, what are the particular constitutional arrangements governing financial intergovernmental relations in these two decentralized or multi-level systems of government, and how do they function? A mere theoretical comparison of the relevant constitutional arrangements in both countries would have only provided a limited view of the situation. The socio-economic and political considerations that impacted on the design of the particular constitutional arrangements and the practical effect of these arrangements was thus also included in this study.

Although the basic fiscal and economic model for government designed by Musgrave was developed for a unitary system of government, the principles developed by him can also be applied to a multi-level system of government.<sup>1</sup> In fact, economists, for example, Oates and King have built on this basic model for their research on public finance in multi-level or federal systems of government.<sup>2</sup> It is evident from the discussions in **Chapter 3** that there is no economic blueprint for the design of financial intergovernmental relations in such systems of government. However, the economic guidelines or principles developed over time by economists such as Oates and Musgrave provide useful and important guidance in this respect.<sup>3</sup> Their basic theoretical model is used as a point of departure for both developed and developing countries. The basic economic theory applied to decentralized systems of government suggests that expenditure responsibilities regarding the provision of public services can best be provided for at a regional or local level and should be decentralized, while macro-economic stabilization, redistribution of income and the provision of those public goods that affect the welfare of all citizens, for example, defence, should be centralized.

It is important to note that in terms of the financial and economic considerations discussed above, resource allocation to the various levels of government must be equitable and aimed at reducing disparities while economic theory requires that the most efficient resource allocation should be obtained. When there are disparities between levels of government or between sub-national units, some form of financial equalisation is required to reduce these. Equity and efficiency considerations are as important in designing the financial equalisation mechanisms in decentralized systems of government as they are in the basic allocation of expenditure responsibilities and revenue resources to the various levels of government.

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<sup>1</sup> Musgrave *The Theory of Public Finance* (1959) 3; See discussion under **3 1**.

<sup>2</sup> Oates *Federalism and Government Finance* in Quigley & Smolensky (eds) *Modern Public Finance* (1994) 129; Oates *Fiscal Federalism* (1993) 14 – 17; King *Fiscal Tiers: The Economics of Multi-Level Government* (1984) 36.

<sup>3</sup> Musgrave *Public Finance in a Democratic Society* (Vol III) (2000) 333; Wehner “Fiscal Federalism in South Africa”, 2000 *Publius: The Journal of Federalism* 47 49; Oates *Fiscal Federalism* 37.

When one applies the economic theory as discussed above to Germany and South Africa, it is evident that it played a role, whether explicit or implicit, in the development of the actual constitutional arrangements regarding allocation of financial resources and constitutional obligations.<sup>4</sup> In addition, the political considerations and the socio-economic conditions prevalent at the time of drafting the two constitutions also played a part and it is therefore appropriate to consider the combined effect of all these factors.

The serious socio-economic needs of the people of Germany resulting from the devastation of World War II called for a major rebuilding of the country. This process included economic reconstruction initiatives, assistance from the Allied Occupation Forces, the development of a new constitution and the election of new political leaders. In the process of negotiations and consultations that led to the design of the Basic Law, the Allied Occupation Forces played an important role. Political considerations, for example, the need to diffuse power to prevent the abuse of power and the prevailing socio-economic needs of the people influenced this process that finally resulted in the Basic Law. A compromise reached in the Parliamentary Council on the constitutional arrangements regarding the division of obligations and allocation of financial resources was essential to this process and the final drafting of the Basic Law.<sup>5</sup> Some of the important considerations that influenced the discussions in the Parliamentary Council were the need to develop a modern economy, the promotion of a welfare state in accordance with the principle of uniformity of living standards (*Einheitlichkeit der Lebensverhältnisse*), and the recognition of the financial autonomy of the *Länder*.<sup>6</sup> The huge war debt and occupation costs became the responsibility of the *Bund*.<sup>7</sup> While the socio-economic situation in the country dictated that most of the taxing powers should be allocated to the *Bund* in order to effectively deal with the economic rebuilding of the country, other considerations led to the decentralisation of powers and a particular

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<sup>4</sup> See discussion under 2 1 1, 4 2 1 and 4 2 2.

<sup>5</sup> Fischer-Menshausen *Das Finanzwesen* in Von Munch *Grundgesetzkommentar* Band 3 (1996) 876; Klein *Bund und Länder nach der Finanzverfassung des Grundgesetzes* in Benda *Handbuch des Verfassungsrechts* (1983) 863 865.

<sup>6</sup> Kilper & Lhotta *Föderalismus in der Bundesrepublik Deutschland* (1996) 97.

<sup>7</sup> Art 120 of the Basic Law; Fischer-Menshausen "Die Abgrenzung der Finanzverantwortung zwischen Bund und Ländern" in *Die Öffentliche Verwaltung* (November 1952) 673.

division of obligations between the *Bund* and the *Länder*.<sup>8</sup> It can thus be concluded that a combination of political considerations, economic guidelines and socio-economic needs resulted in the specific constitutional arrangements contained in the Basic Law.

In South Africa, during the early nineties when the new constitutional order had to be developed, there was likewise a combination of factors that impacted on the process. There was a common understanding amongst all political groups that South Africa required a new constitutional order that would lead to the creation of a democratic system of government. There were, however, diverse views regarding the detail of such a new constitutional system. From the start of the constitutional negotiations political considerations, such as the structural arrangements of government, intergovernmental relations and the content of a bill of rights, rather than economic considerations dominated the process.<sup>9</sup> Socio-economic considerations such as the extreme poverty in some areas, the huge economic disparities between communities and the significant infrastructure needs concerning matters such as housing and schools received political attention and thus featured prominently in the constitutional negotiations. Guidelines in terms of economic theory did play a role, albeit not a very prominent one as politics seems to have dominated. The final result was a political compromise between the main political forces in the country that emphasized unity while providing for a decentralised form of government.<sup>10</sup>

Expectations of the South African public and the international community were high and there was a great deal of pressure on the negotiating parties to reach a compromise. Although part of the political compromise, the decentralization of expenditure

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<sup>8</sup> Fischer-Menshausen "Die Abgrenzung der Finanzverantwortung" 673.

<sup>9</sup> See discussion under 2 2 1 and 4 2 2.

<sup>10</sup> Preamble, sec 1 and 40 of the Constitution; Wehner "Fiscal federalism in SA" 47; Haysom *Federal Features of the Final Constitution* in Andrews & Ellmann *The Post-Apartheid Constitutions* (2001) 504 507; Van Wyk "'n Paar opmerkings en vrae oor die nuwe Grondwet", 1997 (60) *THRHR* 377 391. See discussion under 4 2 2.

responsibilities in the 1996-Constitution is in line with economic theory.<sup>11</sup> The allocation of revenue sources remains highly centralized resulting in a vertical fiscal gap between the national and provincial spheres of government that requires some form of financial equalisation. The particular revenue sharing model included in the 1996-Constitution was part of the political compromise reached in the constitutional negotiations. It is thus concluded that, although there was a combination of factors that impacted on the design of the new constitutional order in South Africa, political considerations had the biggest influence on the final product, the 1996-Constitution.

The differences in constitutional philosophy prevalent when Germany and South Africa were drafting their constitutions also influenced the drafting of their own specific constitutions and this in turn influenced the functioning of the two systems. In Germany the “bottom up” approach in the creation of the new German state is reflected in the constitutional division of powers between the *Bund* and the *Länder*. In the allocation of constitutional obligations to the two levels of government there is inter alia a list of exclusive functions allocated to the *Bund* and the residual legislative powers vest in the *Länder*. In contrast, South Africa’s constitution making followed a “top down” approach. Nine provinces were created in 1993 as products of the Constitution and the allocation of constitutional obligations to the three levels (after 1996 called spheres) of government followed the devolution of power route. In South Africa’s case the national government is vested with residual legislative authority while provincial and local governments have legislative authority over specified functional areas. There was not much of a federal culture in South Africa while Germany had a long history of federalism. The political debates at the time of drafting the Basic Law and the South African Constitution were quite different and took place in different eras of the twentieth century. After the War there was a real concern that the new German state should not allow too much power at the federal level. There was strong support, from the Allied Forces and the existing *Länder*, for a decentralized or federal system of government where the *Länder* would play a key role. In the case of South Africa a dominating concern in the constitutional

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<sup>11</sup> Wehner “Fiscal federalism in SA” 70 – 71.

negotiations was to avoid the fragmentation of the past and to build a new united democratic South Africa with a decentralized system of government, but one where the balance of power would rest with the national government. This historic difference explains the different approaches in the drafting of the respective constitutions and is crucial to a better understanding of the functioning of the financial intergovernmental relations systems in Germany and South Africa.

A significant characteristic of the German constitutional system is *Bundestreue* that regulates the relationship between the *Bund* and the *Länder* and between the *Länder* themselves. It is specifically in the field of financial intergovernmental relations that *Bundestreue* plays an important role. It is concluded that *Bundestreue* that is closely linked to the federal state principle, guides the *Bund* and the *Länder* in their interaction with one another and determines their rights and obligations. The principle of *Bundestreue* influenced the adoption of the principles of cooperative government and intergovernmental relations in Chapter 3 of the South African Constitution that describes the relationship between the three spheres of government in South Africa.<sup>12</sup> Both South Africa and Germany can be described as systems of cooperative federalism or, in terms of Simeon's classification, integrated or shared models in the wide spectrum of federal systems of government.<sup>13</sup> The parallel between the German and the South African constitutional systems is not only important for a better understanding of the general functioning of both systems, but is of particular significance when looking at the functioning of the financial intergovernmental relations within each country.

The subject matter of this study does not only require that one considers the economic and political considerations at the time of drafting the respective constitutions, but it also dictates that one considers the way in which they operate today under the prevailing socio-economic conditions in Germany and South Africa. This is in order to provide a

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<sup>12</sup> De Villiers *Bundestreue: The Soul of an Intergovernmental Partnership* in *Occasional Papers* March 1995 6; Bayer *Die Bundestreue* (1961) 126; see the discussion under 2.3.

<sup>13</sup> Simeon "Considerations in the design of federations: the South African constitution in comparative context" 1998 (13) *SAPR/PL* 42 59.

more comprehensive assessment of the two financial intergovernmental relations systems. It is evident that the functioning of the two constitutional systems takes place within a particular political and socio-economic context. Germany has a highly developed modern economy and is an economic engine of Europe, however, the reunification of Germany placed extra demands on the available financial resources in the country and today, after more than a decade of a united Germany, the new *Länder* still have not reached the same economic strength as most of the old *Länder*. Financial equalisation, as determined in the Basic Law, thus continues to play an important role in providing much needed support to the new *Länder*. South Africa has enjoyed moderate but steady economic growth since 1994, but is still a developing country with huge socio-economic disparities. Poverty in large parts of the country creates a high demand for basic services that must be delivered by provinces and municipalities. This requires that financial equalisation mechanisms continue to play an important role.

This study indicates that the constitutional accommodation of financial intergovernmental relations is not merely about structural or organizational issues that are part of “traditional” constitutional law. In view of the importance of economic theory, socio-economic realities and policy issues relating to financial intergovernmental relations, it is concluded that this study falls within a distinct and multi-faceted part of constitutional law, that could be described as financial constitutional law. The following elements are included in financial constitutional law in decentralised systems of government:

- ◆ Financial and economic considerations in the design and implementation of financial intergovernmental relations;
- ◆ Policy considerations in the design and implementation of financial intergovernmental relations; in other words, the relationship between constitutional law and the relevant political and socio-economic context;
- ◆ The constitutional allocation of financial resources and expenditure functions to the various levels of government;
- ◆ Constitutional and other legal provisions relating to revenue sharing or financial equalisation mechanisms; and



- ◆ Justiciability of the legal provisions dealing with financial intergovernmental relations.

### 8 1 2 Functioning of system

The analysis of the particular parts of the constitutional systems in Germany and South Africa have provided valuable insight into the practical functioning of financial intergovernmental relations, in particular of the financial equalisation processes in each system. It is evident from the analysis that in both cases the respective constitutional arrangements provide the basis for the financial intergovernmental relations between the various spheres of government. This constitutional basis consists of two elements, namely, the allocation of expenditure functions and financial resources to the various spheres of government and the framework for financial equalisation mechanisms. In both cases the constitutional framework is augmented by further legislation that provides the detail financial equalisation arrangements. Although this rough outline is similar in both systems, there are differences in the detail of the respective legal provisions and in the functioning of the two systems.

It is, however, not only legislation that directs the functioning of the two systems, but as discussed in **Chapter 7**, the courts, in particular the *Bundesverfassungsgericht* and the South African Constitutional Court, also play an important role in interpreting the constitutional and other legislative arrangements and in giving guidance to the executive and legislative arms of government. The active role that the *Bundesverfassungsgericht* played over the years, in particular in the four judgments on financial equalisation, contributed to a better understanding of how the constitutional provisions should be interpreted and given effect to.<sup>14</sup> It is evident from these judgments that the fundamental principles of the German constitutional system, in particular the federal state principle and *Bundestreue*, play a key role in the functioning of the financial intergovernmental relations between the *Bund* and the *Länder* and between the *Länder*. The Court has

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<sup>14</sup> BVerfGE 1, 117; BVerfGE 72, 330; BVerfGE 86, 148; BVerfGE 101, 158; see discussion under **7 3**.

reiterated in *Financial Equalisation Case IV* that it is envisaged by the Basic Law that there should always be a careful balance between the solidarity duty of the *Länder* and the *Bund* and the recognition of the financial autonomy of the *Länder*.<sup>15</sup> This applies specifically to the financial equalisation process. This search for a balance will continue to be a focus point at regular discussions and debates concerning financial equalisation in Germany.

Judicial review in cases about financial constitutional issues is not always easy to analyse since the subject matter includes legal and policy issues that are often intertwined. It is the role of the courts to adjudicate such matters and to measure them against the Basic Law or the South African Constitution respectively.

There is a close link or a symbiotic relationship, as Starck points out, between the principles of separation of powers and supremacy of the constitution. The *Bundesverfassungsgericht* as guarantor of the Basic Law plays an important role in giving effect to these principles.<sup>16</sup> This is particularly evident in the judgments of the Court on financial intergovernmental relations. In cases relating to financial equalisation there is often a fine line between a constitutional issue, to be decided by the *Bundesverfassungsgericht*, and a political issue, to be dealt with by the Federal Government or the Federal Parliament. The *Bundesverfassungsgericht* was criticized by some authors for crossing the line in *Financial Equalisation Case IV* and for actually acting as a legislator.<sup>17</sup> This perception of the Court as “legislator” was strengthened when the Federal Parliament used the exact words from the Court’s judgment in the drafting of the *Maßstäbengesetz*, 2001. One could criticize the Federal Parliament for a lack of innovation in drafting the new *Maßstäbengesetz*, but as legislator they did follow

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<sup>15</sup> BVerfGE 101, 158 para A III.4.

<sup>16</sup> Starck *Constitutional Interpretation* in Starck (ed) *Studies in German Constitutionalism* (1995) 47 52; Herzog *The Separation and Concentration of Power in the Basic Law* in Kirchhof & Kommers (eds) *Germany and its Basic Law* (1993) 391 395.

<sup>17</sup> Kämmerer *Föderalismus als Solidarprinzip* in Vitzthum & Winkelmann (eds) *Bosnien-Herzegovina im Horizont Europas – Demokratische und föderale Elemente der Staatswerdung in Südosteuropa* (2003) 195 206.

the easy route and used the wording of the judgment to ensure that the law will be acceptable to the *Bundesverfassungsgericht*.

It can be concluded that there is an important interaction between the Federal Government, Federal Parliament and the *Bundesverfassungsgericht* in matters pertaining to the relations between the *Bund* and the *Länder*, and specifically in relation to financial equalisation issues that lie at the heart of the *Bund-Länder* relations.

Also in the case of South Africa the supremacy of the Constitution and the principle of separation of powers are seen as two closely linked cornerstones of the South African constitutional order. The Constitutional Court stated in this respect that the three branches of government must cooperate to uphold the supremacy of the Constitution.<sup>18</sup> As far as the functioning of the financial intergovernmental relations in South Africa is concerned, the Constitutional Court has not yet had much opportunity to give further content to the meaning of the relevant constitutional provisions. In the absence of a judgment on an intergovernmental dispute regarding the equitable division of revenue, it is difficult to say whether the Constitutional Court would play the same active role as the *Bundesverfassungsgericht* in the development of financial constitutional law. The Constitutional Court's basic conservative philosophy will most likely guide its approach in cases concerned with financial constitutional issues. It is evident from the human rights cases discussed in **Chapter 7** that the Court is quite aware of the interaction between the principle of separation of powers and the supremacy of the Constitution. In upholding the Constitution, the Court made it clear in *Minister of Health and Others v Treatment Action Campaign and Others (No 2)* that it has the authority to decide on the constitutionality of policy issues, even if they have financial implications, but that it cannot decide on the most effective way a government should determine its budget.<sup>19</sup> Although the human rights cases were not concerned with the functioning of the financial

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<sup>18</sup> *President of the RSA v United Democratic Movement* 2003 1 SA 472 (CC) para 25.

<sup>19</sup> 2002 5 SA 721 (CC) para 37; Van Wyk "The enforcement of the right of access to health care in the context of HIV/AIDS and its impact on the separation of powers" 2003 (66) *THRHR* 389 405; see discussion under **7 4 4**.

intergovernmental relations system, it is evident that the implementation of socio-economic rights can have a direct financial implication for government since it has to make provision in its budget to give effect to such rights. This could in turn influence the financial equalisation process if, for example, additional allocations are made to provinces to provide specific treatment for HIV/AIDS patients, thus giving effect to the right of access to health care services.<sup>20</sup>

As far as the functioning of the financial intergovernmental relations system in both countries is concerned, it is evident that different approaches to the design and functioning of financial equalisation have led to different results. In the case of Germany the basic constitutional framework is clear and does not appear to be problematic. The same can, however, not be said of the financial equalisation process and the applicable legislation. The complex nature of the legal provisions governing financial equalisation in Germany seems to add to the problems regarding the functioning of the financial equalisation system. It can, however, be argued that the very detailed and mechanistic formulation of the German Financial Equalisation Act (1993) limits the scope for arbitrary decisions that could be to the detriment of the *Länder*.

In the case of South Africa there is less detail in both the Constitution and in the financial equalisation legislation. This creates a reasonably clear legal framework but leaves ample room for political decisions pertaining to the division of revenue. The one model is not necessarily better than the other. It can, however, be concluded that in developing the appropriate model for a financial equalisation legal framework at least the following issues should be considered, namely:

- ♦ there should be scope for an objective formula that should be the basis of the financial equalisation process, while some flexibility that is important for government as it allows for policy choices and weighing up of expenditure priorities is also important;
- ♦ there should be a balance between detailed provisions and simple language; and

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<sup>20</sup> Sec 27 (1) (a) of the Constitution.

- ♦ there should be a clear constitutional objective concerning financial equalisation.

Co-operative government in South Africa and *Bundestreue* in Germany determine the interaction between the various constituent governments.<sup>21</sup> This is nowhere more visible than in the area of financial intergovernmental relations. The Budget Council in South Africa and its German equivalent, the *Finanzministerkonferenz* (Finance Ministers' meeting) are crucial to the successful functioning of these relations in both countries. It is in these meetings that many discussions regarding financial equalisation take place, guided by the principles of co-operative government and *Bundestreue* respectively. It should, however, be noted that the political contexts in the two countries differ in many ways and this factor impacts on the functioning of the financial intergovernmental relations systems.

There is a further angle to the role of *Bundestreue* and the principles of co-operative government respectively in the functioning of the two financial intergovernmental relations systems. *Bundestreue*, based on the *Bundesstaatprinzip* (federal state principle) in Article 20 of the Basic Law, requires that the *Bund* and the *Länder* have a duty to assist each other and, at the horizontal level, that the financially stronger *Länder* have a duty to assist the financially weaker *Länder*.<sup>22</sup> This is also referred to as the solidarity duty. Financial equalisation in Germany is thus in essence a practical application of *Bundestreue*. This was particularly evident in the period after unification when the rebuilding of the new *Länder* and their eventual inclusion in the financial equalisation system called for extraordinary high financial contributions by the *Bund* and the financially stronger old *Länder* that all made sacrifices to assist the financially weaker *Länder*.<sup>23</sup>

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<sup>21</sup> See discussion under 2 3 and 4 4; Von Münch *Staatsrecht Band I* (1993) 237, 240.

<sup>22</sup> See discussion under 5 3; Häde *Finanzausgleich* (1996) 257; *BVerfGE* 1, 117 131; Wieland "Die verfassungsrechtliche Rahmenordnung des Finanzausgleichs", 1988 (8) *Jura* 410 419.

<sup>23</sup> See discussion under 5 5.

The duty to assist is not without limits. This was clearly pointed out by the *Bundesverfassungsgericht* in the latest case on financial equalisation, when it stated that reasonable financial equalisation does not mean an absolute equalisation of the financial disparity of the *Länder*.<sup>24</sup> Placing limits on the reasonable financial equalisation means that there should be a balance between solidarity and the financial autonomy of the *Länder*. It is therefore concluded that the federal state principle and *Bundestreue* are fundamental to the successful functioning of the constitutional system in Germany and in particular for the financial intergovernmental relations between the *Bund* and the *Länder* and between the individual *Länder*.

The principles of co-operative government in the case of South Africa are, at least in principle, equally important in the functioning of South Africa's financial intergovernmental relations. This has however only been tested in one political context dominated by one party and it remains to be seen how effective it would be in a political setting similar to that of Germany where there is a more even division of power. It is argued that these principles would be of even greater importance in a context where there is competition between provinces and central government and between the various political parties in the provinces.

In terms of section 41 (1) (h) of the Constitution all spheres of government and organs of state must support and assist one another, in other words, there is a "solidarity duty". The fact that the South African provinces have less financial autonomy than the German *Länder* does not detract from the fact that they and the national and local governments must adhere to these principles. Lacking in the case of South Africa is a clear constitutional aim that is directly linked to financial equalisation or division of revenue, for example, to ensure the equality of living conditions throughout the country. The importance of co-operation between all constituent governments in South Africa to give effect to the constitutional requirements regarding financial equalisation should not be

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<sup>24</sup> *BVerfGE* 101, 158 par A III. 4 (c), C I.2 (c).

underestimated and this was in fact mentioned in the *Budget Review 2003*.<sup>25</sup> South Africa still has serious socio-economic needs regarding issues such as housing, water, medical services and schools and to effectively address these needs, a high degree of cooperation between all spheres of government is required. In addition, many municipalities and some provinces still lack sufficient administrative capacity to fulfil their constitutional obligations effectively. Financial equalisation that is aimed both at the equitable distribution of funds to all three spheres of government and at improving the quality of life of everybody in the country, requires a co-operative approach to realize these aims.<sup>26</sup> It is therefore concluded that the principles of co-operative government are fundamental to the practical functioning of financial intergovernmental relations in South Africa.

## **8 2 Current challenges**

An important question relating to the subject of the dissertation is: What important current challenges impact on the functioning of the constitutional systems, and particularly on the financial aspects of the constitutional systems in Germany and South Africa? It would appear that some of the challenges are of a legal nature while others are of a socio-economic nature, but due to the nature of the subject and the fact that legal and socio-economic issues are sometimes interrelated, they are treated simultaneously in this discussion. Although there could be a variety of challenges facing government, the focus in this discussion is on two serious challenges within each country.

### **8 2 1 New improved financial legislation in Germany**

In Germany the *Bundesverfassungsgericht* in the latest case regarding financial equalisation, decided that the system is not functioning as determined by the Basic Law and must therefore be amended to bring it in line with constitutional provisions.<sup>27</sup>

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<sup>25</sup> National Treasury *Budget Review 2003* 239.

<sup>26</sup> See discussion under **6 5 1**; FFC *Framework Document for Intergovernmental Fiscal Relations in South Africa* (1995) iii.

<sup>27</sup> *Financial equalisation case IV BVerfGE* 101, 158. See discussion under **7 2 4**.

Federal Parliament was instructed to follow a different approach to financial equalisation to simplify the legislation. The problem the Court faced was partially a historical issue, namely, it was centered around the question of what “a reasonable equalisation of financial disparity of the *Länder*” means. The problem was exacerbated by the unification of Germany and the huge financial and economic needs that had to be addressed.<sup>28</sup> Today, more than ten years after unification and even after billions of Deutsch Mark and euro have been pumped into the new *Länder* through the German Unity Fund and as a result of financial equalisation, serious socio-economic needs in parts of Germany still exist. The fact that financial disparities between the *Länder* existed historically and continue to exist, implies that there must be some form of financial equalisation in order to give effect to the constitutional aim of ensuring equal living conditions throughout the country. This is not questioned. It is the implementation of this that has caused the problems that were addressed by the *Bundesverfassungsgericht* in 1999.<sup>29</sup>

In its analysis of the functioning of the financial equalisation system vis-à-vis the constitutional framework, the Court in *Financial equalisation case IV* recognized the financial autonomy of the *Länder* on the one hand and the constitutional obligation to assist one another (solidarity duty) on the other hand.<sup>30</sup> In doing so the Court underlined the inherent tension in the Basic Law that forms an essential part of the federal constitutional order that was created in 1949. It is evident from the Court’s judgment that a balanced approach is required to give effect to these and other constitutional requirements in Article 106 and 107 of the Basic Law. The problem is to find the right balance. Addressing the needs of financially weaker *Länder* through financial equalisation, without causing a disincentive for *Länder* to perform well, is quite a

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<sup>28</sup> Already in the first case on financial equalisation (*BVerfGE* 1, 117 para 45) this question was discussed by the Court. See discussion under **5 5** and **7 3**.

<sup>29</sup> *BVerfGE* 101, 158.

<sup>30</sup> *BVerfGE* 101, 158 par C II.2 (c). See Beierl *Reforming Intergovernmental Fiscal Relations in Germany: The Bavarian Point of View* (2001) 8; Bayerische Staatsministerium der Finanzen et al *Die Reform des Finanzausgleichs – Föderale, ökonomische und verfassungsrechtliche Aspekte* (1998) 1.



challenge. The Court has directed the Federal Parliament to follow a balanced approach in creating new legislation to give effect to the constitutional framework.

The very complicated financial equalisation mechanisms contained in the Financial Equalisation Act (1993), in particular with regard to horizontal financial equalisation, were difficult to understand and implement and caused concern among some of the *Länder*.<sup>31</sup> This problem was raised by various parties before the *Bundesverfassungsgericht* in *Financial equalisation case IV* where the financial equalisation system was referred to by some *Länder* as incomprehensible and opaque.<sup>32</sup> Prior to this milestone case Bavaria and Baden-Württemberg advocated a reform of the financial equalisation system at various opportunities and even published a reform proposal for a simplified and more transparent system.<sup>33</sup> The simplification of the legal provisions governing the financial equalisation system remains a challenge, not only to make it more comprehensible but also to create a legal framework for the division of financial resources that is transparent and that promotes accountability. The Court gave a direct instruction to the Federal Parliament to draft a standards law that contains objective criteria for the actual division of finances and which creates a transparent system of financial equalisation.<sup>34</sup>

The adoption of the *Maßstäbengesetz* and the *Finanzausgleichgesetz* followed a compromise reached between the *Bund* and the *Länder* regarding the “best” way to give effect to the decision of the Court. This however did not turn out to be the best result Germany needed. The development of a standards Act raises the question what the status of this Act is. The *Finanzausgleichgesetz* must still be measured against the Basic Law, and now must also be measured against the *Maßstäbengesetz* that clearly cannot have the same or higher status than the Basic Law. The contents of the *Finanzausgleichgesetz, 2001* is not really simpler, and not that different either, when compared to the previous

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<sup>31</sup> See discussion under **5 4**.

<sup>32</sup> *BVerfGE* 101, 158 par A III.9.

<sup>33</sup> Bayerische Staatsministerium der Finanzen et al *Der neue Finanzausgleich – einfach federal gerecht* (1998).

<sup>34</sup> *BVerfGE* 101, 158 par C I. 1 (e).

financial equalisation legislation. It is debatable whether the *Maßstäbengesetz*, 2001, and the *Finanzausgleichgesetz*, 2001, meet the constitutional requirements and if it really is an improvement on the current legislative arrangements contained in the *Finanzausgleichgesetz*, 1993.

## 8 2 2 Socio-economic needs of the new *Länder*

The relatively weaker economic situation in the new *Länder* continues to pose a challenge to the *Bund* and the financially stronger old *Länder*. An indication of the economic woes of the eastern *Länder* is their relatively high unemployment compared to that of most of the other *Länder*. According to recent statistics the average unemployment rate in the eastern *Länder* is 18,2%, while the average rate in the western *Länder* is 8,3%.<sup>35</sup> A further example of the weaker financial position of some of the eastern *Länder* is the situation of Berlin, the capital city and one of the sixteen *Länder*. Berlin finds itself in a severe budgetary crisis and made an application to the *Bundesverfassungsgericht* to question the constitutionality of the *Finanzausgleichgesetz*, 1993. This application was based on the solidarity duty of the *Bund* and the other *Länder* to assist a *Land* that is in a severe financial crisis.<sup>36</sup>

In giving effect to the constitutional demand of ensuring equal living conditions in the federal territory the *Bund*, with the assistance of the *Länder*, have to secure financial support for and the economic development of the new *Länder*. While the current solidarity agreement is nearing the end of its lifespan in 2004, a second solidarity agreement (*Solidarpakt II*) was agreed to by the Federal Government and the Ministers-President of the 16 *Länder* on 23 June 2001.<sup>37</sup> This solidarity agreement, with a total expenditure of euro 306 billion, will be implemented from 1 January 2005 for the

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<sup>35</sup> Schmitt "Mühsame Suche nach den Jobs" *Süddeutsche Zeitung* (9. Oktober 2003) 22.

<sup>36</sup> Nölte "Ein 'Notland' hofft auf Solidarpflicht" *Neues Deutschland* (6. September 2003) 1. At the time of writing this dissertation the matter has not yet been heard by the Court.

<sup>37</sup> Bundesregierung *Jahresbericht der Bundesregierung zum Stand der Deutschen Einheit 2003* (September 2003) 20; Bundesregierung "Bundesregierung und Länder einigen sich auf Länderfinanzausgleich und Solidarpakt II" [www.bundesregierung.de/dokumente/Themen\\_A-Z/Aufbau-Ost-.6771/Laenderfinanzausgleich-und-Sol.htm](http://www.bundesregierung.de/dokumente/Themen_A-Z/Aufbau-Ost-.6771/Laenderfinanzausgleich-und-Sol.htm)

following fifteen years. The *Solidarpakt II* provides the legal and financial foundation for the aid programs for the new *Länder*, often referred to as the *Aufbau Ost* (rebuilding of the east), and includes investment aid, incentives and direct financial contributions as part of the financial equalisation process. The focus areas within the *Aufbau Ost* are investment promotion, innovation and research, infrastructure development and job creation.<sup>38</sup> The Federal Government's aim for the *Aufbau Ost* is to create more jobs and training opportunities that would contribute to sustainable economic growth in a modern economy that is directly linked to the constitutional aim of ensuring an equalisation of living standards between the east and the west in Germany. This is a huge endeavour to rebuild the economy and the social fibre of the new *Länder* in the east and will continue to be a major challenge for both the *Bund* and the financially stronger *Länder* in the west for the next couple of years.

### **8 2 3 Good governance in South Africa**

Provinces and municipalities have not yet developed their full potential as constitutionally distinctive governments, and often still lack sufficient administrative capacity and adequate financial resources to fulfil their constitutional obligations. The Butterworth intervention at local government level and the poor record of some provinces and many municipalities in the delivery of services are examples of current problems in the implementation of the constitutional system. This indicates that the initial constitutional dream has not yet been realized.<sup>39</sup> This situation fuels the case of some critics who want to abolish provinces. These problems do however not suggest that the constitutional system per se is flawed, but rather that there are implementation issues that should be addressed. Good governance, including sound financial management and accountability, is not negotiable and is mandated by the Constitution and should be applied to all three spheres of government.

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<sup>38</sup> Bundesregierung *Jahresbericht 2003* 16.

<sup>39</sup> Murray & Simeon "South Africa's financial constitution: towards better delivery?" 2000 (15) *SAPR/PL* 477 503.

Sound public financial management and effective administration are the basis for good governance. In addition, an effective financial intergovernmental relations system would support good governance and improve service delivery.<sup>40</sup> In the case of South Africa transparency and accountability are clear objectives for budgetary processes and financial management stipulated in the Constitution. Effect is given to this requirement inter alia by way of the adoption and implementation of the Public Finance Management Act, 1 of 1999, the national and provincial treasury regulations that followed, medium term financial planning, the improvement of the quality of publications relating to budgets, the division of finances and financial management.<sup>41</sup> The Public Finance Management Act has contributed significantly to better and more regular reporting, improved financial management and more detailed and informative reports on the spending of public funds within the national and provincial spheres of government. This Act is performance and output oriented and in terms of the Act accounting officers are required to submit measurable objectives for each main division within a vote. They must also give account of all votes in an annual report.<sup>42</sup> The National Treasury indicated in the *Intergovernmental Fiscal Review 2003* that, although there has been a remarkable improvement in public financial management, there remains a challenge to bring all government departments and provinces to the same standard of budgeting, financial management and reporting. There is therefore a need to improve the quality of budgeting and financial management.<sup>43</sup>

A major challenge is currently to introduce sound financial management practices to local government in South Africa. These should be similar to those that apply to the national and provincial governments in terms of the Public Finance Management Act. During the second half of 2003 a comprehensive Act, the Municipal Finance Management Act, 56 of

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<sup>40</sup> Murray 2000 (15) *SAPR/PL* 503.

<sup>41</sup> Sec 215 and 216 (1) of the Constitution; National Treasury *Intergovernmental Fiscal Review 2003* (2003) 7.

<sup>42</sup> Sec 27 (4) and 40 (3) (a) of Act 1 of 1999; Visser & Erasmus *The Management of Public Finance* (2002) 256.

<sup>43</sup> National Treasury *Intergovernmental Fiscal Review 2003* 7.

2003, was adopted by Parliament.<sup>44</sup> This Act introduced key financial reforms for local government. The object of the Act is “to secure sound and sustainable management of the financial affairs of municipalities and municipal entities by establishing norms and standards and other requirements” for a range of financial issues, such as budgeting, financial planning, borrowing, reporting and handling of financial problems in municipalities.<sup>45</sup> The 284 municipalities in South Africa face many challenges ranging from developing required skills to developing appropriate administrative capacities required to provide basic services to the poorest of communities. It is essential that all the municipalities be well managed according to sound financial management practices. The implementation of the Municipal Finance Management Act will add a further challenge to municipalities, but it is essential that they obtain the necessary expertise as quickly as possible and follow the proposed financial management prescripts in order to promote good governance and enhance service delivery.<sup>46</sup> Capacity problems and insufficient payment for municipal services continue to hamper the effective functioning of municipalities in South Africa. It remains a challenge to all spheres of government to ensure that administrative and financial management skills are developed to build sufficient capacity at municipal level as this will ensure good governance. National and provincial governments have a constitutional obligation to assist municipalities in this respect. This is an area where much more can be done by assisting weaker municipalities to strengthen the capacity of local government to deliver.

Although the transparency and accountability requirements pose a continuous challenge to all spheres of government in South Africa, it is being attended to in a constructive and evolutionary manner.

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<sup>44</sup> The Act was assented to by the President on 9 February 2004 and published in Government Gazette No. 26019 of 13 February 2004.

<sup>45</sup> Sec 2 of the Municipal Finance Management Act.

<sup>46</sup> Anon “No quick fix” *Business Day* (Monday, 15 September 2003) 6.

### 8 2 3 Addressing HIV/AIDS in South Africa

It is a well-known fact that Sub-Saharan Africa has the highest infection rate of HIV in the world. South Africa, being one of the countries, where the spread of HIV/AIDS is quite high, faces serious social and economic problems.<sup>47</sup> The scope of the HIV/AIDS pandemic in South Africa, in particular in a province such as KwaZulu-Natal, places high demands on the budgets of provinces as provinces are responsible for health care services, where most of the spending on HIV/AIDS takes place. Some demands are also made on education, where awareness and life skills programs are implemented in schools to prevent the spread of HIV/AIDS. As AIDS patients become unable to work and the number of AIDS orphans increases, there is also a higher demand for social service support, which means further pressure on the budgets of provinces and this will then influence the equitable division of revenue.

Although provinces must budget for specific treatment or awareness programs as part of their normal budgets, it is not nearly enough to deal with the high cost of treatment for HIV/AIDS patients. Additional allocations from the national government's share of revenue dedicated to treatment programs (health), awareness campaigns (education) and increased social grants (welfare services) have to be made annually to assist provinces.<sup>48</sup> At an international level the Global Fund to Fight AIDS, Tuberculosis and Malaria was set up in 2001 by Kofi Annan, Secretary General of the United Nations. This is an international effort to assist countries to address these serious diseases on an appropriate scale. Applications for funding can be made via a country co-coordinating mechanism, for example, the South African National Aids Council, to the Global Fund that invites applications every six to twelve months.<sup>49</sup> Two provinces in South Africa have so far been successful in making applications for funding, namely KwaZulu-Natal and recently

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<sup>47</sup> National Treasury *Intergovernmental Fiscal Review 2000* 14.

<sup>48</sup> National Treasury *Intergovernmental Fiscal Review 2001* B20; Schedule 4 Division of Revenue Act, 5 of 2002; Schedule 5 Division of Revenue Act, 7 of 2003.

<sup>49</sup> The Global Fund is managed by an Executive Director and supervised by a Board that is representative of governments, the private sector, non-governmental organizations and people living with AIDS, and the South African Minister of Health also serves on this Board.

the Western Cape. In the case of KwaZulu-Natal the national Minister of Health tried to intervene to have the funds that were allocated to KwaZulu-Natal included in the allocation to the national government as the province did not make its application via the South African National Aids Council.<sup>50</sup> The funding provided by the Global Aids Fund runs into millions of dollars and makes a substantial contribution to assist the provinces in providing appropriate treatment for HIV/AIDS patients, in particular for the prevention of mother to child transmission. There is no constitutional impediment to provinces for sourcing foreign development aid and this can complement provincial budgets for the delivery of services. Foreign development aid or donations are extra-budgetary and thus fall outside the process for the equitable division of revenue, but proper financial administration and reporting is still required. The combat of HIV/AIDS will be one of the biggest socio-economic challenges facing provinces for the next couple of years.

The series of court cases that the Treatment Action Campaign has had against the national Minister of Health and against some of the provinces to get government funding for the treatment of HIV/AIDS patients highlighted the importance of appropriate provision in the respective budgets of the national and provincial health departments for health care services in order to give effect to the specific human rights concerning health matters and to effectively address the HIV/AIDS pandemic.<sup>51</sup> This implies that there is proper recognition of this need in the financial equalisation process.

### **8 3 Reform initiatives in Germany**

The first major reform of financial legislation in Germany since 1969 was agreed to in 2001 when the *Bund* and the *Länder* agreed to a new solidarity agreement (*Solidarpakt II*) and two new pieces of legislation governing financial equalisation, namely a Standards Act (*Maßstäbengesetz, 2001*) and a new Financial Equalisation Act (*Finanzausgleichgesetz, 2001*). The Federal Parliament, acting on a decision of the

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<sup>50</sup> Kahn "Fight over AIDS fund do SA more harm" *Business Day* (23 July 2002) 3.

<sup>51</sup> See discussion under **7 4 4**.

*Bundesverfassungsgericht* on 11 November 1999<sup>52</sup> regarding the constitutionality of the *Finanzausgleichgesetz, 1993*, attempted to give effect to the directions of the Court by passing these two laws.<sup>53</sup> The Court required the Federal Parliament to establish objective standards or measures in terms of which the actual financial equalisation must be done and to develop a new Financial Equalisation Act that would enforce these standards.

Although there is a *prima facie* new approach to financial equalisation flowing from the Court's decision, the Federal Parliament did not provide the objective standards required by the Court and missed an opportunity to provide the real substantial legislative reform that is perhaps needed in Germany. The *Maßstäbengesetz, 2001*, is to a large extent a repetition of the directions of the *Bundesverfassungsgericht* and did not live up to the expectations of providing a set of clear criteria and objective standards for financial equalisation. It did however state that the population valuation is to be used as the criteria for determining the financial capacity of the *Länder*.<sup>54</sup> This *Maßstäbengesetz* did therefore not provide the envisaged legal framework for the new *Finanzausgleichgesetz* to be developed. The new *Finanzausgleichgesetz, 2001*, was instead a product of political negotiations between the *Bund* and the *Länder* and led to the new solidarity agreement to enhance social and economic development in the new *Länder*, namely, *Solidarpakt II*.<sup>55</sup>

Some reform measures were, nonetheless, included in the new *Finanzausgleichgesetz, 2001*. These include:

- ❖ Incentives for *Länder* to increase their own revenue, by excluding part of their tax revenue from the financial equalisation process; and

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<sup>52</sup> *BVerfGE* 101, 158; see discussion under 7 3 4.

<sup>53</sup> See discussion on legislative reform under 5 6.

<sup>54</sup> Kämmerer "Maßstäbe für den Bundesfinanzausgleich? – Dramaturgie einer verhinderten Reform" *JuS* (2003) *Heft* 3 214 216; Kämmerer *Föderalismus als Solidarprinzip* 212.

<sup>55</sup> Kämmerer *Föderalismus als Solidarprinzip* 217.



- ❖ Strengthening the solidarity duty of the *Länder* by special provisions for financial assistance to the poorer *Länder*, including Berlin.<sup>56</sup>

It seems that the Federal Parliament attempted to maintain a balance between financial autonomy and solidarity in the new *Finanzausgleichgesetz, 2001*, following the approach in the Basic Law. Whether the above reform measures were enough to properly attend to the demands for reform of the financial equalisation system is not clear, and whether the two new laws will stand the test of time is debatable as they are already criticized for not complying with the requirements of the Court and the *Maßstabgesetz* for being constitutionally questionable.<sup>57</sup>

Schultze, in a recent article on the challenges to German federalism, suggested that substantial reform of the German constitutional system, and not only the financial equalisation system, is urgently needed.<sup>58</sup> He argued that the new European environment and the growing pressures from within the German constitutional system required a total modernization of the system by creating a multi-level system of government that would allow more autonomy, subsidiarity and competition and more taxing powers for the *Länder*. This reform should attempt to find a balance between cooperation and competition amongst the various constituent units. Whether the first reform steps undertaken by the Federal Government in terms of the financial legislative reform, are part of a bigger constitutional reform process remains to be seen.

There is growing pressure on the Federal Government to undertake major reforms of the social welfare system in order to address the problems of high unemployment, diminishing funds for the payment of old age pensions and the growing cost of the state health care system.<sup>59</sup> Various initiatives to tackle unemployment are being considered,

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<sup>56</sup> Bundesministerium der Finanzen “Der neue bundesstaatliche Finanzausgleich ab 2005” *Monatsbericht* 02.2002 100; Kämmerer *Föderalismus als Solidarprinzip* 220; see discussion under **5 6**.

<sup>57</sup> Kämmerer 2003 *JuS Heft* 3 215; Kämmerer *Föderalismus als Solidarprinzip* 199 – 201.

<sup>58</sup> Schultze “German federalism at the crossroads” 2003 (Vol 3 no 3) *Federations* 13 15.

<sup>59</sup> Mahler et al “Reform-Haus Deutschland” *Der Spiegel* Nr 42 (13. Oktober 2003) 30 – 46; Bundesregierung “Health reform” <http://eng.bundesregierung.de/dokumente/Artikel> (21 May 2003) 1.

for example, shortening the period for which one can claim unemployment and creating more jobs. Less unemployment will have a positive effect on the state pensions and health care systems. The state pension system is under pressure since people tend to now live longer and therefore depend on pension for a longer period, while at the same time there are fewer young people that contribute to the pension scheme due to a declining birth rate in Germany.<sup>60</sup> There is thus a need for reform of the pension system that will enable the Federal Government to continue caring for its senior citizens during their retirement on a basis that will take the current situation into account. The rising cost of maintaining the statutory health insurance system has forced the Federal Government to consider a number of measures that will contribute to a more affordable health system, while maintaining or even increasing the high level of quality medical treatment provided in Germany.

#### **8 4     Prospects and proposals for reform in South Africa**

The South African Constitution provides a framework for government in the three spheres to function, but it requires complementary legislation, for example in the field of financial intergovernmental relations, to strengthen the way government is functioning and to give effect to the Constitution. Much progress has been made since 1997 regarding the development of the new constitutional system through the implementation of the various pieces of financial legislation, for example, the Intergovernmental Fiscal Relations Act, 97 of 1997, and the Public Finance Management Act, 1 of 1999.<sup>61</sup>

There was never any doubt that the cost of implementing the new constitutional system in South Africa would be high. This is even more evident today after the first ten years of democracy. The particular structure of government, namely, three spheres of government with provinces and municipalities being the main service delivery institutions, has an influence on the actual delivery of services. Poverty is still a huge problem in South

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<sup>60</sup> Mahler et al “Reform-Haus Deutschland” *Der Spiegel* 40; Bundesregierung “Pensions” <http://eng.bundesregierung.de/dokumente/Artikel> (1 August 2003) 1.

<sup>61</sup> National Treasury *Intergovernmental Fiscal Review 2003* 7.

Africa and places high demands on the delivery of basic services such as housing, water and electricity. Some of the poorest areas in South Africa are in provinces and municipalities that struggled for years with insufficient administrative capacity required for good governance and effective delivery of basic services. This situation creates a bottleneck in the effective implementation of the constitutional system in South Africa. , Lack of administrative capacity is not inherent in municipal or provincial government, but because these spheres of government are at the coalface of service delivery, any problem relating to effective governance quickly attracts the public's attention.

The existence of problems relating to a lack of capacity and skills in provinces and municipalities and that hamper the effective functioning of the constitutional system, does not necessarily require a reconsideration of the specific distribution of financial resources and constitutional obligations. The problems regarding the functioning of the constitutional system should first be addressed before consideration is given to constitutional changes that would change the constitutional balance and weaken the position of provinces and municipalities in the constitutional order. The debate should not in the first place be about taking away some of the functions of provinces and municipalities in order to address their failures. There should rather be a debate about the means of assistance that can be given to struggling provinces and municipalities to contribute to an optimisation of their respective constitutional roles as important service delivery institutions. This constitutional obligation of both the national and the provincial governments has not been fully utilized.<sup>62</sup> Much more can be done to train staff and to ensure that the correct skills, including managerial skills, are developed and utilized in the provinces and municipalities. It is perhaps too early in the life of the new constitutional system to talk about major constitutional or legislative reforms as some aspects of the system have not yet been fully explored or developed.

Innovative thinking is required to ensure that the budgets of provinces and municipalities are properly spent to enhance good governance. Regular reporting and monitoring

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<sup>62</sup> Sec 125 (3) and 154 (1) of the Constitution.

mechanisms as required by the Public Finance Management Act and other legislation or national policies need to address the problem at hand, but are presently ex post facto mechanisms only. Conditional grants with specific project and reporting requirements also address part of the problem, but conditional grants form only a small part of provincial and local government budgets. Provision is made in the Constitution for the exercise of functions on an agency basis.<sup>63</sup> A practical example of the application of this provision could be that a provincial executive could agree with a municipality that it would act as an agent and manage a housing plan for that municipality for a specified period of time in order to solve the problem of a lack of delivery in that particular municipality. Such an agency agreement must respect the principles of co-operative government.

In order to address the concerns of the National Treasury that some provinces and municipalities do not perform and do not spend their budgets, it may be useful to explore some form of performance contract, similar to those which individual managers within the public service have. Performance agreements would allow for more regular interaction between the national and provincial government departments within a line function area or, more specifically, for the implementation of a specific law. This would require that all parties to such a performance agreement must make a specified contribution, for example, the national department will have to provide assistance to the province to ensure that the agreed targets are met. On what basis should performance agreements be initiated? They can only be developed within the framework of co-operative government and all performance agreements must acknowledge the constitutional status and integrity of government and the organs of state. Although this may be a novel idea for the further development of the constitutional system in South Africa, the notions of equity and accountability as reflected in the Constitution provides a basis for the development of such performance agreements. Section 215 (1) of the Constitution requires that

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<sup>63</sup> Sec 238 of the Constitution.

“National, provincial and municipal budgets and budgetary processes must promote transparency, accountability and the effective financial management of the economy, debt and the public sector.”

This leads one to the question of asymmetry because the suggested performance management approach is focused on individual specific arrangements and cannot meaningfully be achieved in a collective way. Asymmetry is already provided for in the Constitution. Section 125 (3) recognizes that provinces can develop at a different tempo. Some might be able to take on more responsibility than others. If, for example, Gauteng has the administrative capacity to develop and maintain a modern road infrastructure network, they should be allowed to continue developing it and not be hampered because of failures in other provinces. Greater recognition of asymmetry could allow for more flexibility in the delivery of services and in the further development of financial intergovernmental relations. This could create new opportunities for partnerships between provinces or even between provincial departments and others where there is a need for support and strengthening of capacity.

It is concluded that there is a need for refining the South African constitutional system, in particular as far as it relates to financial constitutional issues. There should be a continuous weighing up of issues to find the right balance between fiscal autonomy and solidarity and between centralization and decentralization of the constitutional system that functions within a specific socio-economic context.<sup>64</sup> Such an exercise would assist in improving the functioning of the constitutional system by making the necessary adjustments or fine-tuning it from time to time.

Furthermore, the progressive realization of socio-economic rights does not warrant legislative reform, but requires that government take proper account of the requirements of the Bill of Rights and pronouncements by the Constitutional Court in this respect. This implies that provision should be made in the respective budgets of the national,

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<sup>64</sup> Murray 2000 (15) *SAPR/PL* 500.

provincial and local governments, and also in the financial equalisation process to make financial provision, within available resources, for giving effect to socio-economic rights. This must be done within the context of large-scale poverty and high levels of unemployment throughout South Africa that place additional demands on the available financial resources in the country. Attention should be turned to the effective implementation of the Constitution instead of to the call for making major constitutional amendments that would change the existing constitutional model.

The National Treasury is currently working on some reforms that are aimed at enhancing the quality of budgeting and financial management in all three spheres of government. These reforms include the development and publishing of service delivery measures to complement financial information as published in budgets and reports, and the introduction of financial management rules and practices for local government. These will be similar to that applicable to the national and provincial governments, and will be done through the Municipal Finance Management Act.<sup>65</sup>

It is envisaged that as far as financial equalisation is concerned there will be some reform in the near future. These reforms will reflect the new census data and secondly, may include an amendment to the financial equalisation formula. The National Treasury, in reaction to the reform proposals made by the Financial and Fiscal Commission in the *Financial and Fiscal Commission Submission: Division of Revenue 2003 – 2004*, indicated that “a comprehensive and fundamental review of the equitable share formula” will be undertaken during 2003 with the aim of introducing some reforms during 2004.<sup>66</sup> This review will include consideration of the impact of new census data on the current division of revenue and the impact of possible provincial and local government taxes and will actively involve the FFC. In the 2004 Budget Review the National Treasury indicated that the review process has started, but that it will only be completed in time for

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<sup>65</sup> National Treasury *Intergovernmental Fiscal Review 2003* 7.

<sup>66</sup> National Treasury *Budget Review 2003* 253.

the 2005 budget.<sup>67</sup> As a result, the formula for the provincial equitable share was kept intact for 2004 but was updated with new data.

In **Chapter 6** the results of the comparison between the financial equalisation systems in Germany and South Africa indicate that there are a few lessons to be learnt from the German financial intergovernmental relations system, some of these are to be avoided and some others to be considered.<sup>68</sup> Against this background the following specific recommendations for reform of the South African financial intergovernmental relations system are made:

- (i) Provinces should have a stronger say in the decision-making process in the National Council of Provinces, in particular as far as it relates to the passing of legislation regarding the raising of taxes and regarding financial equalisation or division of revenue, in order to limit the imbalance between decision-making about financial resources and the expenditure obligations of provinces and to enhance accountability at provincial government level. This would require a constitutional amendment regarding the voting procedure in the NCOP. In view of the current political situation where the ANC has an overwhelming majority in the National Assembly and in the nine provinces, such an amendment would however have little effect.
- (ii) Provincial accountability could be further strengthened by the development of own sources of tax revenue. Such a development would be in line with accepted economic theory on fiscal federalism.<sup>69</sup> This could be done through ordinary legislation and does not require any constitutional amendment. This is a complex issue that warrants a balanced approach that recognizes the legitimate need for more own sources of revenue for provinces and the need for sufficient funds required for financial equalisation.

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<sup>67</sup> National Treasury *Budget Review 2004* 258.

<sup>68</sup> See discussion under **6 6**.

<sup>69</sup> See discussion under **3 1**.

- (iii) The constitutional provisions on the division of revenue in the South African Constitution should be amended to include a simple but clear objective, such as “the improvement of the quality of life of all citizens”, or “promoting equality in living conditions throughout the country”. This would enhance the quality of the provisions on the division of revenue by giving it a more substantive purpose than just stating that there must be an equitable division of revenue with a view to provide sufficient funding for the provision of basic services. Such an objective should be the fundamental principle of the financial constitution. The fact that the Constitution is the supreme law in the country implies that the inclusion of such an objective in the Constitution would give it extremely high status, and legislation on the division of revenue can then be measured against it. This would assist the courts in adjudicating cases relating to financial constitutional issues. This recommendation implies a constitutional amendment.
- (iv) A special management unit, consisting of a small team of experts in public administration, financial management and constitutional law, should be established to act as a rapid response team that must address crises in provinces and municipalities. National Treasury should provide the funding for the establishment and functioning of this unit. Skills development and capacity building in all spheres of government are long term investments and should receive continuous attention in order to strengthen good governance. The special management unit is a short term intervention mechanism that should be utilized in those areas where there are serious problems, and it should be done for a short period of time only.
- (v) An asymmetric approach to the further development of provinces should be followed in order to allow for flexibility in the delivery of services in different parts of the country and to create the opportunity for some form of performance agreement between national and provincial governments and between provinces and municipalities in specific fields.



In conclusion, this study has shown that the distribution of financial resources and constitutional obligations in decentralized systems such as that of Germany and South Africa is done by way of a basic constitutional framework that is augmented by further detailed legislation, in particular regarding financial equalisation. It is also concluded that the legal framework cannot be considered in isolation since it functions within a specific political and socio-economic context that impacts on the way financial intergovernmental relations are conducted. Lastly, it is concluded that clear objectives for financial equalisation, preferably contained in the constitution, are essential and that a direct link between the fundamental principles of the constitution and the actual division of financial resources and obligations can add value to a better understanding of the functioning of the constitutional system.

## GLOSSARY

<i>Ausgleichsberechtigte Länder</i>	Receiving <i>Länder</i>
<i>Ausgleichspflichtige Länder</i>	Contributing <i>Länder</i>
<i>Ausgleichsmeßzahl</i>	Equalisation measure
<i>Bezirk</i>	District
<i>Bund</i>	Federation
<i>Bundesergänzungszuweisungen</i>	Additional federal grants
<i>Bundesrat</i>	Federal Council
<i>Bundesstaatprinzip</i>	Federal state principle
<i>Bundestag</i>	Federal Assembly
<i>Bundestreue</i>	Federal comity
<i>Bundesverfassungsgericht</i>	Federal Constitutional Court
<i>Deutscher Bund</i>	German Confederation (1815 – 1866)
<i>Deutsches Reich</i>	German Empire
<i>Deutscher Zollverein</i>	German Customs Union (1834 – 1871)
<i>Einheitlichkeit der Lebensverhältnisse</i>	Uniformity of living standards
<i>Einigungsvertrag</i>	Treaty of Unification
<i>Einkommensteuer</i>	Income tax
<i>Einwohnerveredelung</i>	Population valuation
<i>Einwohnerzahl</i>	Number of inhabitants
<i>Finanzausgleich</i>	Financial equalization
<i>Finanzkraftmeßzahl</i>	Financial capacity measure
<i>Finanzministerkonferenz</i>	Finance Ministers' meeting
<i>Finanzmonopole</i>	Financial monopolies
<i>Finanzverfassung</i>	Financial constitution
<i>Fonds Deutsche Einheit</i>	German Unity Fund
<i>Gemeinden</i>	Municipalities
<i>Gemeindefinanzreformgesetz</i>	Municipal Financial Reform Act
<i>Grundgesetz</i>	Basic Law
<i>Horizontaler Finanzausgleich</i>	Horizontal financial equalization

<i>Körperschaftsteuer</i>	Corporate tax
<i>Konnexitätsprinzip</i>	Connecting principle
<i>Land/Länder</i>	German state/states
<i>Landtag</i>	State parliament
<i>Landesrecht</i>	Provincial law
<i>Nationalversammlung</i>	National Assembly
<i>Nivellierung</i>	Absolute equality
<i>Parlamentarische Rat</i>	Parliamentary Council
<i>Planungsausschüsse</i>	Planning committees
<i>Prinzip des örtlichen Aufkommens</i>	Principle of place of origin
<i>Solidaritätszuschlag</i>	Solidarity duty
<i>Umsatzsteuer</i>	Turnover tax
<i>Verfassung</i>	Constitution
<i>Vertikaler Finanzausgleich</i>	Vertical financial equalization
<i>Zölle</i>	Customs duties
<i>Zollverein</i>	Customs Union

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